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American Institute of Certified Public Accountants. Insurance Companies Committee

AICPA

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Institute of
Certified
Public
Accountants

AUDITS of STOCK LIFE INSURANCE COMPANIES

With Conforming Changes as of May 1, 1993

Industry Audit Guide

AICPA
American Institute of Certified Public Accountants

AUDITS of STOCK LIFE INSURANCE COMPANIES

With Conforming Changes as of May 1, 1993

This edition of the industry audit guide *Audits of Stock Life Insurance Companies* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in Appendix L of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Industry Audit Guide

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Committee on Insurance Accounting and Auditing on the application of generally accepted auditing standards to audits of financial statements of stock life insurance companies. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for stock life insurance companies. AICPA members should be prepared to justify departures from this guide.

Preface

Applicability

At the time of the issuance of the initial exposure draft of the audit guide, the Committee reserved decision as to the applicability of parts of the guide to mutual life insurance companies. During and subsequent to the exposure period of the draft of the guide, substantial consideration was given to whether mutual life insurance companies should be required to present financial statements in the same form and following the same accounting principles as stock companies. The nature of mutual life insurance company operations, as distinguished from the operations of stock life insurance companies, and the purpose of mutual life insurance company financial statements were the principal considerations.

Some members of the Committee believed that the guide should apply to mutual companies and to stock companies; others believed that some, but not all, of the principles of accounting and reporting for stock companies should be applicable to mutual companies; and others believed that regulatory accounting and reporting practices for mutual life companies should be considered to be in conformity with generally accepted accounting principles. There was no consensus on any of these views. However, the Committee recognized that there is a need for an audit guide for stock companies, and there is general agreement as to the appropriate accounting and reporting principles for these companies. Consequently, the Committee believes that the needs of the situation are best served by publishing an audit guide which applies to stock life insurance companies but not to mutual companies until applicability of generally accepted accounting principles to mutual life insurance companies has been determined.

Notwithstanding the foregoing, Part I, that section of Part III entitled "Reliance on Actuaries," and Appendix D, "Supplementary Internal Control Structure Questionnaire for Life Insurance Companies," and Appendix E, "Glossary of Terms," should be used by auditors as a guide for audits of mutual life insurance companies. In addition, principal accounting policies and practices of mutual life insurance companies should be disclosed, as required by Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*. Such disclosures should normally include those required for other business enterprises. The following should be considered in determining additional disclosures to be made:

a. A general statement that the financial statements have been prepared on the basis of accounting practices prescribed or permitted by insurance regulatory authorities.
b. Method of accounting for acquisition costs, maintenance and settlement costs.
c. Reserving methods and description of mortality tables and interest rates used.
d. Method of accounting for dividends to policyholders.
e. Method of accounting for income taxes.
f. Treatment of nonadmitted assets and mandatory securities valuation reserve.

Effective Date

Audit guides generally do not require an effective date. However, because the restrictions on expression of reliance on actuaries and the requirements for qualified, adverse or disclaimed opinions discussed in Part III will change practice which has heretofore been acceptable, such restrictions and requirements will not be effective with respect to auditors' reports on financial statements for periods ending before December 31, 1973. However, where practicable, independent public accountants should encourage early adoption of the principles of accounting and financial reporting discussed in Part II.

Acknowledgments

The Committee on Insurance Accounting and Auditing has worked closely with the Joint Committee on Financial Reporting Principles of the American Life Convention and the Life Insurance Association of America, and with the Joint Actuarial Committee on Financial Reporting of the American Academy of Actuaries, Canadian Institute of Actuaries, Conference of Actuaries in Public Practice and Society of Actuaries. The Committee wishes to express its sincere appreciation for the significant contributions made by these committees in the preparation of this audit guide.

Committee on Insurance, Accounting and Auditing

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Chapter 1

Introduction

1.01 As indicated in the preface, this audit guide is applicable principally to stock life insurance companies. It has been prepared to provide guidance to independent auditors in auditing and reporting on financial statements of life insurance companies. It contains information concerning the nature and conduct of the life insurance business, accounting practices prescribed or permitted by insurance regulatory authorities, the differences between regulatory practices and generally accepted accounting principles, auditing procedures and reports related to life insurance companies.

1.02 The accounting and reporting principles discussed in Part II are significant changes from existing practice. Their adoption in practice is likely to result in problems and questions. It was not practical in the guide to discuss all of the problems that could arise in the application of these principles or to identify or suggest solutions to some existing problems. Further experience in the implementation of the guide will undoubtedly lead to improvements. The Committee and industry groups will continue to work to provide additional guidance.

Organization

1.03 The guide has been organized into the following sections:

- Part I deals with the nature and conduct of the business and accounting and reporting practices prescribed or permitted by regulatory authorities. It also includes outlines of suggested auditing procedures applicable to accounts maintained in conformity with regulatory practices.
- Part II discusses the differences between regulatory practices and generally accepted accounting principles and sets forth appropriate guidelines for accounting and financial reporting in conformity with generally accepted accounting principles. It also includes suggested additional auditing procedures resulting from the application of generally accepted accounting principles.
- Part III describes the various circumstances under which auditors may be required to give opinions and sets forth examples of opinions to be given in the circumstances.
- Appendix A includes illustrative financial statements for a company reporting in conformity with generally accepted accounting principles and supplementary data required to reconcile net income and stockholders' equity presented in financial statements prepared in accordance with regulatory practices to such amounts determined in conformity with generally accepted accounting principles.
- Appendix B discusses the procedures involved in accounting for the deferral and amortization of acquisition costs.
- Appendix C discusses deferred income taxes applicable to life insurance companies which are taxed under the Life Insurance Company Income Tax Act of 1959.
- Appendix D is a suggested internal control structure questionnaire intended to be used as a supplement to general internal control structure questionnaires. It is designed to assist the auditor in

obtaining an understanding of the internal control structure of the life insurance company whose accounts are maintained in conformity with regulatory practices.

- Appendix E is a glossary of terms commonly used in the life insurance industry.

PART I

Nature and Conduct of Business

Chapter 2

History and General Nature of Business

2.01 The function of insurance is to provide for the pooling of risks among many persons who are exposed to similar risks. The primary purpose of life insurance is to provide financial assistance at the time of death. The long period of coverage involving the risk of death, a risk which increases with age, is the distinguishing characteristic by which life insurance is set apart from other forms of insurance.

2.02 Life insurance is a relatively modern development, although its origin has been traced back to around 1700 in England. Other forms of insurance were in existence long before life insurance. The development of life insurance required a greater sales effort and resulted in the full-scale agency system.

2.03 One of the earliest forms of life insurance was administered on an assessment basis. Under this plan the surviving members of a group would be assessed so that a certain amount could be paid to the beneficiary of a deceased member of the group. This form of life insurance had inequities as well as practical limitations. Obviously, it was often difficult, and sometimes impossible, to collect an assessment from all members. With the development of mortality tables, it became possible to charge a more equitable premium based upon the probability of death of an individual within his own age group.

2.04 Since many individuals found an increasing premium objectionable, the level premium concept was introduced. Today most life insurance is sold on a level premium basis under which the annual premium remains constant. Under this plan, the amount of the premium is based upon an assumed interest rate, and upon the frequency of deaths according to the mortality table used by the insurance company. The premiums collected, after deducting benefits and other costs each year, are accumulated at interest. This accumulation, when combined with future net premiums and future investment income should generate a sum sufficient to pay the claims resulting from the deaths of the members of the insured group. The liability which corresponds to this fund is referred to as the "policy reserve." See paragraphs 3.33 through 3.45, "Premiums," for a further discussion of this subject.

2.05 Life insurance companies may also issue policies on some or all of the lives in a particular group—such as employees of a company. The accounting for group policies differs in a number of respects from that required for policies on individual lives. Much of the record-keeping for some group policies is handled by the insured groups and transactions are reported periodically to the insurance company. Premiums are often adjusted based on experience.

2.06 Life insurance companies also write annuity policies, on either an individual or a group basis, under which the insured (annuitants) receive fixed payments over varying periods. A recent innovation in the field of annuities is the "variable annuity" under which amounts paid in during the "accumulation period" are invested in common stocks with the annuity payments based, in part, on the investment performance of such stocks.

2.07 Another major line of business for the life insurance industry is health insurance (accident and health). This type of insurance takes many forms, and can be on an individual or group basis. Generally speaking, the broad coverages of accident and health insurance are for loss of income and for hospital and medical expenses.

Types of Organizations

2.08 The following are the principal types of life insurance organizations:

2.09 *Stock Companies.* A stock company is a corporation organized to earn profits for its stockholders by performing services for the benefit of its policyholders and their beneficiaries. Generally, the stockholders are not liable in case of bankruptcy or impairment of capital. In most states, stock companies may issue both participating and nonparticipating policies. Participating policies are those under which a portion of the earnings arising from those policies are returned to policy owners in the form of dividends. Nonparticipating policies are those under which the policyowners have no right to share in the earnings of their policies.

2.10 *Mutual Companies.* A mutual company is an incorporated entity without private ownership interests which operates for the benefit of its policyholders and their beneficiaries. With limited exceptions, mutual companies issue only participating policies. In a mutual company, participating policyholders have the right to vote for members of the company's board of directors or trustees. In some states, the insurance laws provide that upon liquidation of a mutual insurance company, the net assets are distributed among the existing policyholders of the company, and the prior policyholders have no claim against such assets.

2.11 *Fraternal Benefit Societies.* A fraternal benefit society resembles a mutual insurance company in that, although incorporated, it does not have capital stock, and it operates for the benefit of its members and their beneficiaries. Policyholders participate in the earnings of the society and the policies stipulate that the society has the power to assess its members should the legal reserves become impaired. Management of a fraternal benefit society is a representative form of government whereby members elect delegates to a national convention which in turn elects the officers and directors. Fraternal benefit societies operating under a lodge system are exempt from federal income taxation.

2.12 *Assessment Companies.* An assessment company is an organized group with similar interests such as a religious denomination or a professional group. Assessment companies represent only a minor segment of the industry. In many states no new assessment companies can be organized; most such existing companies have reorganized on a "legal reserve assessment company basis" which means that they charge a fixed premium and maintain the reserves required by law, but retain the right to call for additional premiums. These companies are required by law to charge no less than the required minimum rates and also to have an assessment clause only until such time as they accumulate surplus in excess of the legal minimum requirement.

2.13 The types of organization may vary, depending upon specific state regulations.

Operating Organizations

2.14 The internal organizations of companies are generally divided into two broad segments—home office and field operations.

2.15 *Home Office.* The business of a typical home office of a life insurance company may be departmentalized according to the following functions:

- Agency department—responsible for sales promotion, supervision of field forces and sales training.

- Underwriting department—responsible for the evaluation of risks and the issuance of policies.
- Policy service department—responsible for servicing changes in policies pertaining to such items as address, beneficiary and mode of payment; for notification and collection of premiums due; for conserving business; and for payment of benefits and claims. (In many companies these functions are performed by other departments.)
- Actuarial department—responsible for determining premium rates, nonforfeiture values, calculating and verifying the adequacy of policy reserves, determining dividends on participating policies, designing new policies, analyzing experience and assisting in long range planning.
- Investment department—responsible for managing the company's investments.

2.16 In addition to the above, there will usually be other functions typical of business operations in general.

2.17 *Field Operations.* For field operations most companies employ either the general agency or branch office system or some combination thereof and may, in addition, rely on brokers to sell life insurance.

2.18 The distinction between a general agent, a branch office salesman and a broker is based on the nature of their relationship to the insurance company. In all cases, they submit applications for insurance to the company for acceptance or rejection. A general agent usually is an independent contractor. A branch office salesman may be an employee of the insurance company, an independent contractor, or an employee of the general agent. A broker is an independent agent who places business with various companies. The vested rights to renewal commissions depend on contractual agreements. General agents and brokers commonly have vested rights to commission; however, branch office salesmen may not have vested commission rights.

2.19 *General agency*—A general agency is often granted an exclusive territory in which to produce business for the company, although this practice varies among companies and frequently does not apply to those companies operating in metropolitan centers. General agents agree to promote the company interest, pay their own expenses (except as reimbursement may be provided for by contract), maintain a satisfactory agency force and secure sub-agents. They perform services in connection with securing applications for insurance and the issuance of policies. General agents are compensated primarily on the basis of a percentage of the premiums they produce plus certain allowances. This may be a gross percentage out of which the general agents pay the sub-agents whom they appoint or the brokers from whom they secure business or it may be a specific overriding commission, with sub-agents' commissions paid directly by the company.

2.20 *Branch office*—The branch office is operated by a manager who is usually a salaried employee of the company, and whose compensation may be partly based on production. Branch office salesmen are often called field underwriters. Expenses of the branch office are usually paid by the home office.

2.21 *Brokers*—Insurance brokers are independent agents who solicit business and place it with various companies. They submit applications for acceptance or rejection directly to the company, through a general agency or its sub-agents, or through other brokers.

2.22 *Other field operations*—Some companies sell debit (or account) insurance in small amounts through door-to-door salesmen; these policies may be issued on either ordinary or industrial policy forms. Premiums on such insurance are generally collected on a weekly or monthly basis. Some companies obtain new business through mail order solicitation, personal referrals, news media advertising, telephone, and other methods.

Reinsurance

2.23 Life insurance companies insure a great many persons and collect from them amounts expected to be sufficient in the aggregate to meet all benefits and expenses as they become payable. To accomplish this purpose, the company must insure a large enough number of persons for the law of averages to operate. Frequently, however, an insurance company may write a policy on a risk for an amount which is either beyond its financial capacity to absorb or in excess of an amount it is willing to absorb. Therefore, it will reinsure a part of the risk with another insurance company retaining only as much as it can or is willing to absorb. Most companies usually set a limit on the amount of risk they will retain. This limit is called their retention and may differ depending on a person's age or whether that risk is standard or substandard. The company transferring the risk is called the ceding company, and the company to which the risk is transferred is called the assuming company or the reinsurer.

2.24 The term reinsurance also applies to the "sale" of all or a part of a company's insurance in force to another company. In this case, the policy service responsibility (collection of premium, etc.) is transferred to the assuming company and all relations with the writing company are terminated. Such a transaction may arise upon the insolvency or liquidation of a company or may be instituted by management decision (with regulatory approval) to sell a portion of the business.

2.25 The principal types of reinsurance agreements are discussed in paragraphs 3.27 through 3.32.

Regulation

2.26 *State.* The insurance industry is a business vested with the public interest; an insurance company acts in a fiduciary capacity and thus requires regulation. Statutes in all states provide for the organization and maintenance of an insurance department charged with the responsibility of supervising insurance companies and enforcing their compliance with the law.

2.27 While statutes vary, their principal objective is the development and enforcement of measures directed toward solvency, fair dealings with policyholders and uniform financial reporting.

2.28 The statutes generally restrict insurance companies to certain types of investments; prescribe methods of valuation of securities and other assets; require maintenance of minimum reserves, capital, and surplus; and define those assets not permitted to be reported as "admitted assets" in annual statements filed with insurance departments. (See paragraphs 5.08 through 5.11, "Nonadmitted Assets.")

2.29 Usually the statutes also provide for certain standard provisions to be incorporated in policies and for the insurance department to review and approve the various forms of policies. Agents, brokers and salesmen must qualify for licenses granted by the insurance department before they may solicit insurance business.

2.30 The statutes provide for the filing of annual or other periodic statements, in prescribed form, with the insurance departments and for the examination of insurance companies by the insurance departments at stated intervals. Annual statements are required to be filed on a calendar year basis.

2.31 In the majority of states, organization of insurance companies may not be undertaken without the authorization of the insurance department. In those states where such authorization is not required, approval of the insurance department is usually necessary for the completion of organization.

2.32 Most insurance departments consist of an insurance director, commissioner or superintendent-in-charge having one or more deputies, staffs of examiners, actuaries, attorneys, and clerical assistants. A commissioner is usually given many discretionary powers and authority to issue rules and regulations necessary to assure compliance with the statutes he is required to enforce.

2.33 *National Association of Insurance Commissioners.* The commissioners of the various states organized the National Association of Insurance Commissioners (NAIC) which meets semiannually to deliberate on various subjects of interest to insurance regulatory authorities. The Association has a number of standing committees that meet throughout the year to develop various plans and proposals for submission at the semiannual meetings of the commissioners. Although the findings of the Association are not in themselves binding on any state, its recommendations for new rules or procedures or for changes in the old ones are usually accepted and adopted by the states in the form of appropriate legislation or regulations.

2.34 Important activities of the NAIC include financial reporting and examination. Special committees have developed and are maintaining a uniform annual statement and an examiner's manual which is in the nature of an audit program.

2.35 To minimize duplication of examinations, the NAIC designed uniform "association examination" procedures. For this purpose, the country is divided into six zones with one state commissioner in each zone designated as chairman of that zone. Whenever a domiciliary state decides that an insurance company within its jurisdiction is subject to association examination, it notifies the executive secretary of the NAIC who advises the chairmen of all the zones, designating those zones eligible to participate on the basis of the writings within the zone. The chairman of each zone eligible to participate designates one of the states within his zone to represent the zone in the examination. The examining staff, therefore, consists of the domiciliary state examiner, who supervises the examination, and also of representatives of all or some of the zones in which the company transacts business. The report of the association examination is filed with the chairman of each zone. The association examination generally satisfies the statutory examination requirements of each state in which the company transacts business, thereby eliminating the duplication which would occur if each state conducted its own examination of all companies within its jurisdiction. The auditor should review the report on examination for company compliance therewith.

2.36 * *Securities and Exchange Commission.* Despite certain exemptive provisions of the Securities Exchange Act of 1934, the shares of a number of stock life insurance companies are registered with the Securities and Exchange Commission. Some companies that have registered under the 1934 Act have done so in connection with the listing of their shares on a national securities

* Note—Generally, the exemptions from SEC filings discussed in these paragraphs no longer exist. [Updated information for SEC registrants will be provided in a future revision.]

exchange. Others have been required to register under the 1934 Act because they have formed holding companies, which are not life insurance companies and, as such, do not qualify for exemption from registration under the 1934 Act. Companies, including life insurance companies, registered under the 1934 Act must comply with annual and periodic reporting requirements and are subject to the proxy solicitation and insider trading rules. Life insurance companies making public offerings are required to register such offerings under the Securities Act of 1933 and must thereafter undertake to comply with the annual and periodic reporting requirements of the 1934 Act; however, these companies are not under the proxy solicitation or insider trading rules of such Act so long as they meet the attendant requirements for exemption therefrom. Reports submitted to the Commission, including prospectuses and proxy statements, must generally be in accordance with the applicable published rules and regulations of the Securities and Exchange Commission, including those for form and content of financial statements prescribed by Article 7A of Regulation S-X.

2.37 * At present, life insurance financial statements are exempt from certification in reports or registration statements filed under the Securities Exchange Act of 1934. Form 10 is the general form for registration of securities pursuant to Section 12 of the 1934 Act and Form 10-K is the general form for annual reports thereunder. The Securities and Exchange Commission in May 1971 issued a notice of a proposed amendment to delete this exemption for insurance companies from certification; however, the exemption was retained in order to permit the accounting profession, in collaboration with the insurance industry, to develop and promulgate accounting guidelines for life insurance companies which will enable the financial statements of such companies to be certified in accordance with generally accepted accounting principles. This exemption is not available under the Securities Act of 1933. Thus, the financial statements of a life insurance company are required to be certified when they are included in registration statements for the offering of its own securities for sale under Form S-1, for example, or for the offering of securities for sale under Form S-6 by its separate account business for variable annuities or other separate account business for which the life insurance company is acting as sponsor.

Mechanics of Recording Transactions

2.38 Most life insurance companies maintain their general ledger on a cash basis but prepare their statutory financial statements on a modified accrual basis. These statements vary from generally accepted accounting principles as defined in Part II. The adjustments necessary to convert the accounts from a cash to an accrual basis are not usually recorded on the books. Instead, these are usually recorded on working papers.

2.39 One reason for the use of cash basis accounting by life insurance companies is that a life insurance company generally conducts its business on a cash basis. Another reason is that certain of the exhibits contained in the annual statements filed with regulatory authorities require details of income and expense items on a cash basis with only the totals being adjusted to an accrual basis. Since the accounts underlying the income and disbursement pages of the annual statement (usually referred to as the "convention blank" or the "Association statement") do not reflect all financial transactions which occur during the period, the trial balance taken from a life insurance com-

* Note—Generally, the exemptions from SEC filings discussed in these paragraphs no longer exist. [Updated information for SEC registrants will be provided in a future revision.]

pany's general ledger is incomplete compared to the usual commercial enterprise.

2.40 Because of the use of cash basis accounting for recording purposes and accrual basis accounting for reporting purposes, assets are referred to either as "ledger assets" (those assets recorded on the books, such as cash, bonds and stocks, mortgage loans, furniture and fixtures, etc.) or as "non-ledger assets" (those assets not recorded on the books, generally consisting of premiums deferred and uncollected, investment income due and accrued, adjustments for unrealized appreciation or depreciation from cost to market values, etc.).

2.41 Some items recorded in the general ledger, such as furniture and fixtures and certain agents' balances are considered "non-admitted" assets for statutory purposes and are, therefore, excluded from the statutory balance sheet.

2.42 In addition to "ledger assets" and "non-ledger assets," there are "ledger liabilities" and "non-ledger liabilities." For most life insurance companies, "ledger liabilities" consist of liabilities arising directly from cash transactions, such as payroll deductions, remittance and items not allocated, etc., while "non-ledger liabilities" consist of liabilities that do not arise as a direct result of cash transactions, such as policy reserves, claims liabilities, etc.

2.43 For financial statement purposes, and for the statutory Association statement, a life insurance company must maintain records of claims pending, paid, compromised, or resisted. A "claim register" is usually maintained to provide a record of claims and their disposition. Since the disbursement journal will only record the actual cash paid, the claim register will be the usual source for the auditor to verify the exposure of the company for pending or disputed claims, and the effect upon the inventory of policies entering into the computation of the life reserves at year end.

2.44 The reserve for life insurance and other contracts, which is normally the largest liability of the insurance company, does not usually appear on the general ledger, but in a subsidiary record. The policy reserve file, in spite of its importance and size, is not part of the bookkeeping system and is not under general ledger control; thus, it must be inventoried at the reporting date. (See chapter 6, "Liabilities," for a discussion of auditing procedures.)

2.45 The typical life insurance company will record most of its assets on its books, since most of its assets normally arise from cash transactions. However, it will record very few of its liabilities, since very few of its liabilities are the direct result of cash transactions. Therefore, the auditor will normally find an account on the books entitled, "Excess of assets over liabilities," "Balance account," or some similarly entitled account. This account is usually the balancing figure between ledger assets and ledger liabilities and will include ledger capital for those companies where ledger capital is not separately stated on the books. It is only in combination with the year-end inventories of non-ledger assets and non-ledger liabilities that the "Balance account" has any meaning for financial statement purposes.

Chapter 3

Insurance Operations

3.01 Revenue from insurance operations generally consists of premiums and revenue produced through reinsurance agreements. Considerations for supplementary contracts and dividends left to accumulate at interest are included as income in life insurance company annual statements but are not true revenue since they are merely a reapplication of funds arising from policy proceeds and dividends.

Types of Policies and Contracts

3.02 Policies and contracts usually issued by a life insurance company may generally be designated by the following broad classifications:

1. Life insurance policies.
2. Annuity contracts.
3. Accident and health contracts.

In addition, certain life insurance companies may issue policies which incorporate features of two or three of the broad categories shown above (e.g., an insurance-with-annuity policy). Each of the types of policies is commonly issued both on a participating and on a nonparticipating basis.

3.03 *Life Insurance Policies.* Life insurance coverage consists of the following basic classes:

1. Whole-life.
2. Endowment.
3. Term.
4. Other.

3.04 Whole-life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary-life (straight-life) policy stipulates that premiums are to be paid during the life of the insured. A limited-payment policy is one for which premiums are payable over a stipulated period of time (10, 20, 30 years, etc.). A single-premium policy requires a lump-sum payment at the inception of the policy.

3.05 Endowment policies provide insurance protection over the term of the endowment (i.e., from inception of the policy to the maturity date). Such contracts stipulate payment of the face amount of the policy to a beneficiary if the insured dies during the endowment period. However, if he is still living at the maturity date, the insured will receive the face amount of the policy. Endowment contracts can mature at a specified age of the insured or at the end of a specified period of time. The premiums for contracts of this nature are usually payable over the endowment period, but the premiums can be on a single-payment or limited-payment plan.

3.06 Both whole-life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

3.07 Term policies provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to his beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole-life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Since the premium for term insurance provides for neither maturity benefits nor higher death rates at advanced ages, such policies do not usually accumulate cash surrender values. Collection of premiums for individual insurance may be by mail, where a notice of premium due is sent to the payor, or may be on the debit basis whereby an agent regularly calls at the home of the insured to collect small premium amounts. Usually, the more popular plans of debit life insurance are industrial plans paid up at age 65 or 70 or 10-pay or 20-pay life. Ordinary plans may also be administered on the debit basis.

3.08 In addition to individual policies, life insurance companies offer group life insurance, which insures lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold.

3.09 In addition to the policies and contracts for life insurance mentioned above, there are other life insurance contracts which are becoming more prominent, such as credit life insurance. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

3.10 In addition to the wide variety of whole-life and endowment policies which are available from life insurance companies, the basic policies can be supplemented by the use of riders which are attached to and made a part of the contract. It is fairly common to provide for waiver of premiums through the use of a rider in the event of disability of the insured or for an accidental death benefit. The typical accidental death benefit is often referred to as double indemnity which means that the company will pay twice the amount of the policy if the insured dies through accidental means.

3.11 *Annuity Contracts.* An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees.

3.12 The main types of annuities are the following:

3.13 *Straight-life annuity*—The straight-life annuity provides for periodic payments to the annuitant as long as he lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.

3.14 *Life annuity with a period certain*—The life annuity with a period certain works essentially the same way as the straight-life annuity, except that if the annuitant dies before the end of the specified period, payments are continued to a beneficiary until the specified number of payments is completed.

3.15 *Refund annuity*—The refund annuity is similar to the annuity certain. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.

3.16 *Joint and survivorship annuity*—The joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

3.17 *Variable annuity*—At present, variable annuities for individuals or groups are being introduced throughout the life insurance industry. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with investment experience. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Some variable annuities provide for a guaranteed minimum death benefit during the annuity consideration accumulation period.

3.18 *Accident and Health Insurance Contracts.* There is a great variety of accident and health contracts which life insurance companies may issue, but most contracts can be generally categorized as follows:

1. Protection against loss of income through partial or total disability.
2. Reimbursement of expenses
    a. Hospital expenses, laboratory services, drugs, and so forth.
    b. Surgical or medical expenses.

3.19 Much of the above coverage is currently being furnished under group contracts. Coverage furnished under individual contracts can be further subdivided according to the insured's right to continue his policy and the limitations on the insurer's right to increase premiums.

Underwriting Procedures

3.20 *Selection of Risk.* Underwriting procedures involve the selection of risks; applicants for insurance can be classified as standard risks at standard rates, as substandard risks at special rates, or as risks which are considered as uninsurable. Uninsurable risks are rejected and are not written by the insurance company.

3.21 Experience shows that more than 90% of the applicants for life insurance will fall under the classification of risks that are insurable at standard rates. Approximately 5 or 6% of the applicants fall into the classification of substandard risks, and the balance of applicants are considered uninsurable risks.

3.22 An application for life insurance requires information such as the applicant's age, sex, occupation, and marital status. It also includes other basic information, most of which relates to historical information about the applicant. The application should also contain comments by the agent which might have an effect upon the insurability of the applicant or the class in which he may fall for insurance rating purposes.

3.23 A medical report may be completed before the risk is submitted to the life insurance company for review. This report usually has two parts. The first part contains questions related to medical history, which the applicant answers with the assistance of a medical examiner designated by the company. If the medical history does not appear routine, the medical examiner will probably request additional information from the applicant's physician. The second part of the medical report is a summary of the examining physician's findings. A medical examination may or may not be required depending on the amount of insurance applied for, the age of the applicant or other factors. Each company has its own guidelines in this regard; in any event, the application is likely to include health questions.

3.24 Another source of financial and personal information about the applicant is the inspection report which, for larger policies, is usually obtained from an independent agency.

3.25 Based on the information contained in the application, the medical report, and the inspection report, the applicant is rated as a standard or substandard risk or as uninsurable.

3.26 *Issuance of the Policy.* If an applicant is an insurable risk, a policy (contract) is prepared for insurance. This is generally done at the company's home office where a policy number is assigned to each policy and where overall numerical control of policies is maintained. After a policy is prepared and a policy number assigned, the policy is usually transmitted to the applicable general agent or branch office for delivery to the policyholder. The initial premium is collected at this time unless it was received with the application. Close control must be exercised over policies delivered but not paid for by the policyholders. Generally, the agent must remit the collected premium or return the prepared policy to the company within a specified period of time.

Reinsurance, Ceded and Assumed

3.27 In addition to any excess risk over the company's retention, which will be ceded to another insurance company, some life insurance companies will assume insurance risks from others.

3.28 Reinsurance can be effected through agreement arranged on the following bases:

1. Facultative reinsurance—Each risk or portion thereof is reinsured individually, the reinsurer having the option to accept or reject it.
2. Automatic reinsurance—An agreed portion of business written is automatically reinsured, thereby eliminating the necessity for submitting each risk to the reinsurer for acceptance or rejection.

3.29 The following are the most usual types of reinsurance agreements, though many variations exist:

1. Yearly Renewable Term (YRT)—This is also called Annual Renewal Term (ART) and Risk Premium Reinsurance (RPR). When reinsurance is ceded on this basis, the principal company purchases from the reinsurer one-year renewable term insurance for the net amount at risk (face less reserve) on the portion of the policy reinsured, at annual premium rates published by the reinsurer. Regardless of the original plan of insurance, the reinsurer sets up one-year term reserves on the net amount at risk, and the ceding company takes a corresponding reserve offset. The YRT method transfers only the mortality risk to the reinsurer.
2. Coinsurance—When reinsurance is ceded on a coinsurance basis, the ceding company pays the reinsurer the gross premium at the ceding company's rate on the portion reinsured. The reinsurer reimburses the ceding company for its commission outlay and usually pays an additional amount toward the ceding company's expenses. The reinsurer is liable for its share of policyholder dividends (as declared by

the ceding company), surrender values, death claims, and any other benefits covered by the premium. Thus, the reinsurer sets up reserves on the original plan basis and the ceding company takes a corresponding reserve offset. The effect of coinsurance is to transfer the surplus drain of the reinsured portion of new issues to the reinsurer (in addition, of course, to the mortality risk and risk of loss from early lapse).

3. Modified coinsurance—May be described most simply as coinsurance with mean reserves held by the ceding company. In addition to the transactions required by coinsurance, a "reserve adjustment" payment between reinsurer and ceding company is made each year. The reserve adjustment is calculated as the increase in mean reserves from one December 31 to the next, less an interest element, and may be positive (payable to the principal company) or negative (payable to the reinsurer).

3.30 The legal rights of the insured are not affected by reinsurance. The company issuing the insurance policy remains liable for payment of policy benefits.

3.31 Most ceding companies have a separate reinsurance unit or department that maintains reinsurance records. The reinsurer usually bills the ceding company monthly. Reinsurance premiums are paid by the ceding company on an annual basis without regard to the mode of payment selected by the policyholder.

3.32 Generally, the accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct writing business, and the amounts for reinsurance transactions are usually netted against the related accounts in financial statements.* (For example, the premium account is decreased for premiums related to insurance ceded.)

Premiums

3.33 There are two types of premiums calculated by life insurance companies: gross premiums and net premiums.

3.34 The gross premium is the premium charged the insured; it represents the actuary's judgment of the amount which must be charged to the policyholder to be competitive with other insurers and at the same time accumulate a fund which, together with interest, will be adequate to provide for all the policy benefits, acquisition costs and other expenses, margins for contingencies, and the desired level of profits.

3.35 The net premium for a policy is associated with calculation of the statutory reserve liability and is based on the assumptions as to mortality and interest used in calculating the statutory reserves. These assumptions must lie within certain limits prescribed by state insurance laws and thus do not necessarily bear any relationship to the mortality and interest rates assumed in computing the gross premium.

3.36 The difference between the gross premium and the net premium is referred to as the "loading." The term loading is a misnomer since this difference is a hypothetical figure and does not necessarily represent an

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, specifies the accounting by insurance enterprises for the reinsurance (ceding) of insurance contracts and applies to financial statements for fiscal years beginning after December 15, 1992.

allowance for expenses and profit. In fact, some companies have gross premiums for some plans and issue ages that are equal to, or less than, the net premium, thus producing zero or negative loadings.

3.37 Generally, companies that write participating business charge more than for a comparable policy sold on a nonparticipating basis. However, most, if not all, of the extra amount may be returned to the policyholder in the form of dividends. For a discussion of dividends to policyholders, see pagagraphs 3.51 through 3.64, "Benefits Under Policies and Contracts."

3.38 Policyholders may elect to pay life insurance premiums in annual, semiannual, quarterly, or monthly modes. However, an additional charge is made if an annual premium is not paid because of the insurer's increased collection expenses, loss of interest, and, in some cases, extra mortality cost in the year of death.

3.39 Usually, the agent selling the policy is empowered by the company to collect the premium that is initially due. However, after the initial premium has been paid, it is customary for the policyholder to be billed by the company. This procedure, of course, does not hold true in the case of debit life insurance for which the agent usually collects premiums at the policyholders' homes on a weekly, biweekly, or monthly basis.

3.40 An increasingly popular form of collecting premium payments is the automatic check plan. Many companies now give the policyholder the option to authorize checks to be automatically drawn against his account on a monthly basis for the payment of premiums. Under such plans, the policyholder need not write a check; at the specified time during the month the company will simply draw a check on the policyholder's account.

3.41 If premiums are not paid by the due date there is a grace period (perhaps 30 or 31 days) during which the premium may still be paid and the policy will not lapse. However, if a premium has not been paid by the end of the grace period and any additional time granted, the policy may be lapsed. When this occurs, the nonforfeiture option selected by the insured will go into effect. The policyholder may at some point request reinstatement, which may require evidence of insurability. Many policies provide for payment of unpaid premiums by an "automatic premium loan" (a) to the extent that the cash surrender value of the policy permits such a loan and (b) if, as provided by some policies, the insured has indicated that he wants this option to take effect any time that premiums have not been paid.

3.42 One of the basic assumptions generally made in calculating the statutory policy reserve is that the net annual premium for each policy has been collected on the anniversary date of the policy regardless of the actual payment mode elected by the policyholder. To balance this overstatement of liability on policies on which the full yearly net premium has not yet been paid, a net deferred and uncollected net premium asset is set up. Therefore, the premium income for a life insurance company should include the equivalent of one net annual premium for each life insurance policy that is in force and on which premiums are still being paid. (See paragraph 5.15, "Life Insurance Premiums and Annuity Considerations Deferred and Uncollected.")

3.43 In addition to premiums, insurance companies include considerations for supplementary contracts and dividend accumulations as revenues. Supplementary contracts are options exercised by beneficiaries relating to the disbursement of policy proceeds (e.g., death benefits) in other than a lump-sum payment. For example, a beneficiary may elect to receive periodic payments over a period of time.

3.44 The statutory accounting for supplementary contracts requires a charge to benefits or some other appropriate disbursement account and a credit to revenue representing the consideration for a supplementary contract. For contracts without life contingencies a reserve is established at year end for the remainder of the sum not yet paid to the beneficiary. As a result, the transaction is treated as though a lump-sum death benefit was paid initially to the beneficiary and then returned in the form of a payment for a supplementary contract. For contracts with life contingencies actuarially determined, reserves are required.

3.45 Similar accounting results when a policyholder elects to have dividends accumulate or have them applied to buy additional insurance. In such cases, dividend expense is charged and consideration for dividend accumulations or premiums for additional insurance are credited. A liability for accumulated policyholders' dividends or a reserve for additional insurance purchased is established at each year end, with a corresponding charge to operations.

Commissions

3.46 Agents are compensated by commissions on business written. The first-year commission rate is usually much higher than the renewal commission rates. The commission is usually limited to a specified period even though the policy may remain in force beyond that time. After a period of 10 or 15 years, many companies pay smaller nonvested renewal compensation known as "service fees."

3.47 The commission scale differs with each type of policy. Accident and health policies usually pay smaller commissions the first year than life insurance policies; renewal commissions are paid over a similar period of time. One example of the rate of commission on an ordinary life policy would be 55% of the premium in the first year and 5% in the succeeding nine years. In order to compete for agents, some companies pay substantially higher first year and renewal commissions. An example of the rate of commission on an accident and health policy would be 40% of the premium in the first year and 10% for the next nine years.

3.48 Some companies permit all or a part of the renewal commissions to vest with the agent even though he may withdraw from his agency contract before the renewal commission period has terminated. Other companies do not permit renewal commissions to vest with the agent; consequently, the agent loses his rights to further commissions upon termination of his agency contract.

3.49 Additional compensation is provided by some companies to supplement the commissions to agents. Such compensation is usually based on the amount of business written by the agent and on other factors such as persistency of the written business. It is also common for companies to have agreements with general agents for reimbursement of certain expenses. Certain states have statutes that limit the amount of expenses that may be reimbursed under such agreements; these statutory limitations are usually complex and are normally based on premiums, insurance in force, etc. Many companies provide pension and other fringe benefits for their agents similar to those provided for employees.

3.50 It is often difficult for a new agent to earn enough commissions early in his career to provide adequate income. Accordingly, many companies make advances to new agents to supplement commission income. In many companies the advances are made against future commissions and must be repaid to the company out of such future commissions. If an agent leaves a company before his advances are repaid, he usually has an obligation to repay these advances. As a practical matter, all or a part of these obligations are often not collected by the company except to the extent of future commissions which would otherwise have been paid to the terminating agent. Consequently, all states require that agents' advances be classified as nonadmitted assets. Agents' credit balances, however, must be included in liabilities.

Benefits Under Policies and Contracts

3.51 *Types of Benefits.* Death benefits under life insurance contracts are paid in a lump sum or under other arrangements which may be elected by the policyholder or the beneficiary. Once it is established that the death claim is proper, payment of the death benefit is made. In addition to the face amount of the benefits, life insurance companies may pay interest on the proceeds from date of death to the date the amount is disbursed.

3.52 Other benefits such as matured endowments, annuity payments, surrender payments, policyholder dividends, and disability benefits may involve a greater aggregate dollar amount than death benefits. These benefits may be paid to the insured or to someone that the policyholder has designated. If the insured lives to the maturity of an endowment insurance contract, the stipulated proceeds are paid at maturity. If the insured dies before the endowment matures, the company will pay a death claim in the normal fashion.

3.53 Annuity payments are made by the life insurance company to the designated person in accordance with the terms of the annuity contract.

3.54 Surrender or loan values usually accrue under whole-life or endowment contracts and are paid, or are available, on surrender of, or borrowing on, the policy.

3.55 Mutual companies and many stock companies write participating contracts. Many life insurance companies compute the dividends allocable to a particular policy according to dividend formulas that are based on asset share studies or other forms of analyses. These studies or analyses are intended to identify the accumulated earnings considered applicable to blocks of policies. As the funds accumulated on these policies exceed the amounts determined to be required to meet expenses and benefits according to their terms, dividends are declared and thus constitute a refund based on actual emerging experience.

3.56 Disability benefits include waiver of premium during the disability period and also loss of income benefits. Health insurance policies, offered by many life insurance companies, may provide hospital, surgical, medical, or loss of income coverage.

3.57 *Processing Procedures.* The processing procedures for payments of benefits generally involve a determination that the contract is in force and that such payments are being made in accordance with the contract.

3.58 In the case of disability payments, there is a medical question as to whether the insured has, in fact, been disabled. In this regard, life insurance companies generally obtain statements from physicians and/or hospitals to satisfy themselves that the person has been disabled. In addition, disability payments do not commence until a required minimum period of disability has been completed. Of course, if the disability is not permanent, the payments are contingent on the continuance of disability.

3.59 When death claims are presented, they should be entered in the claim register. A claim number is usually assigned sequentially to each claim as it is registered and a claim file is initiated. It must be determined whether the policy or policies under which the claim was submitted were in force at the time of death.

3.60 If the policy was in force at the time of death, the company obtains proof of death if such proof of death was not received with the claim. Documents used to substantiate the insured's death usually consist of a certificate of death and a statement from a physician.

3.61 The statement from the physician may be very important if the policy is in the contestable period, usually within two years of its issuance. If death occurs during this period and there is a material misstatement by the insured in the application, the company is usually not legally required to pay the face amount of the contract. However, in such cases, premiums paid are usually returned.

3.62 After determining that the policy had been in force and that the death of the insured has occurred, the company proceeds to determine that provisions of the contract have not excluded the risk which caused the death. For example, the policy may have stipulated that the contract did not provide coverage in the event the insured died while piloting a private plane. If death is by suicide occurring within the suicide exclusion period (usually one year from the date of issue), premiums are returned, but the payment is recorded as a death benefit. Cause of death is also a most important consideration in the interpretation of contract provisions for double indemnity benefits.

3.63 The next important phase in processing is for the company to determine the amount to be paid to the beneficiary. If a policy loan is outstanding on the contract, the amount of the loan will be deducted. Conversely, any amount of advance premiums on deposit, dividends left at interest, additional insurance purchased by dividends, and any terminal dividend credits are usually added to the face amount together with interest on the proceeds.

3.64 The policy under which the death claim has been submitted may involve reinsurance. If so, information regarding the policy will be supplied to the reinsurance department so that proper reimbursement will be received from the reinsurer.

Increase in Policy and Contract Reserves

3.65 The life insurance company's summary of operations will include a charge for the aggregate increase in the actuarially determined reserves for policies and contracts with life contingencies, for supplementary contracts without life contingencies, for dividend accumulations, and for accident and health policies.

General Expenses and Taxes

3.66 General expenses and taxes are usually recorded on a cash basis during the year with appropriate accruals being made at year end. Most general expenses and taxes represent items normally encountered in other types of business enterprises. Expense account classifications are prescribed by regulatory authorities.

3.67 Certain expenses and taxes are allocated to investment operations and are deducted from gross investment income.

3.68 Rent expense includes a charge for occupancy of a company's own buildings, the contra to which is included in investment income. The cost of furniture and equipment may be either charged to expense or capitalized and depreciated over the useful lives in the normal manner. If costs are capitalized and depreciated, the undepreciated balances are usually required to be treated as nonadmitted assets; an exception is usually made for EDP equipment when the cost exceeds a stipulated amount.

3.69 Taxes (other than federal income taxes), licenses, and fees include the following:

1. Real estate taxes.
2. State insurance department licenses and fees which are charged by various insurance departments including cost of examinations made by the insurance departments for licensing of agents.
3. State taxes on premiums which are based on premiums received on lives within the borders of each taxing authority in which the company is licensed to do business. Tax rates vary among states, averaging about 2%. In some cases, counties and municipalities also levy taxes based on premiums. These taxes are generally considered to be in lieu of other state and local franchise and income taxes.
4. Payroll taxes.

Outline of Auditing Procedures

3.70 For this and the other areas of auditing discussed in this guide, the auditor should obtain a sufficient understanding of the internal control structure to plan the audit and to determine the nature, timing, and extent of tests to be performed. An example of a supplementary internal control structure questionnaire intended to assist an auditor in considering the internal control structure of a life insurance company is presented in Appendix D.

3.71 The audit procedures applicable to premiums and other considerations, commissions, and policy benefits are somewhat interrelated and it is important that the auditor understand these relationships at the outset of his work. Since most of the auditing of these accounts constitutes a test of procedures, much of this work can usually be performed at an interim date.

3.72 A general outline of a program for the audit of premiums, commissions, benefits, and expenses is presented in the following sections.

3.73 *Premiums and Other Considerations.* A number of policy files should be selected and examined to determine that the company's accounting records and procedures are adequate and proper.

3.74 As part of his audit procedures involving the underwriting department, the auditor should satisfy himself, through tests, that safeguards surround the issuance of policies. In most life insurance companies policies are not prenumbered, but they are assigned policy numbers at the home office. Accordingly, other controls must be established for policies; for example, the auditor should determine that policies delivered to agents but not issued to policyholders have been accounted for by the company. Some companies control this by billing the agent upon delivery of the policy.

3.75 As to reinsurance, the auditor should read the company's bylaws and minutes to ascertain the limits to be retained on various types of risks. Retention limits may also be shown in the reinsurance treaties and in correspondence with reinsurers. The auditor should also determine whether the company has assumed any reinsurance from other companies. In connection with reinsurance transactions, the auditor should obtain copies or abstracts of reinsurance treaties or agreements. During the tests of premiums and benefits, it should be determined that transactions are being recorded in accordance with applicable reinsurance agreements. The auditor may also consider it appropriate to confirm reinsurance transactions or balances directly with reinsurers. When a company has reinsured a significant portion of its risks, the auditor should satisfy himself that each assuming company is financially sound.

3.76 In addition to the procedures mentioned above involving underwriting and policy issue, the auditor should test premium billing and accounting. Such tests should include renewal premiums as well as first-year premiums. For selected policies in force, the auditor should check the calculation of the related premiums to the appropriate premium rate tables. He should also determine that appropriate premium amounts are billed, accounted for, and subsequently collected.

3.77 Premiums received but not yet applied are usually maintained in a suspense account. The auditor's tests should be designed to determine that the company is properly clearing these items from suspense on a timely basis.

3.78 It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc.

3.79 Tests of premiums can be correlated with audit tests of premiums paid in advance, premium deposit accounts, policy loans, dividends, commissions, surrenders, claims, and reserves.

3.80 *Commissions.* Prior to beginning specific auditing of commissions, the auditor should develop a thorough understanding of the relationships between premiums paid and commissions earned. He should obtain copies of the various agreements with agents regarding compensation and expense reimbursement. A test of specific commission transactions can be related to the premium tests mentioned above. Alternatively, a number of commission transactions may be selected independently for testing. The auditor should determine that the commission transactions selected have been calculated in accordance with the provisions of the specific agreement. He should also determine that aggregate commissions are being properly recorded and subsequently disbursed. Consideration should be given to confirming commissions paid and balances unpaid as of a specific date.

3.81 The auditor should determine that agents' expense reimbursements are made in accordance with agreements with agents and the applicable state insurance law. The auditor may also wish to review expense reports and supporting details periodically submitted by agents.

3.82 *Benefits Under Policies and Contracts.* Death claims should be tested by reference to the related claim files. Each file selected should be reviewed to determine that it contains appropriate support, such as a certificate of death, statement from a physician, the returned policy, etc. The file should also indicate that the company has determined that premiums on the policy were paid through date of death, whether there were any policy loans, whether the risk which caused death was covered, and whether there was recoverable reinsurance, etc. It is necessary to test whether the policies which matured, were surrendered, or terminated by death (for which claims have been paid or are pending payment) have been deleted from the listing of policies used in calculating reserves. If pending claims have not been deleted from the reserve listing, the reserves thereon should be deducted from the amount of the pending claim.

3.83 For death claims submitted under group life insurance contracts, the auditor may consider visiting the group administrator's location in order to verify the validity of the death claims in those cases where the records are maintained by the administrator.

3.84 Matured endowments should be tested to determine that payment is subject to a precontrol of all endowments maturing within the year. The tests should determine that all such payments are in accordance with the contract and have been properly approved.

3.85 Cash surrenders should be tested to determine that the amount paid is in accordance with policy terms and that the policy has been surrendered and cancelled.

3.86 Benefits paid under accident and health contracts should be tested to determine that the policy was in force, that proper support exists for the payment, that the benefits paid are in accordance with the terms of the contract, and that the claim data are properly recorded.

3.87 The aggregate amount of dividends that may be paid to policyholders should be compared with the amount approved by the board of directors. The auditor should determine that benefits are properly allocated and applied to the participating policies.

3.88 Consideration should also be given to direct confirmation of benefit payments with policyholders or beneficiaries, especially where payments are made to agents for delivery.

3.89 *General Insurance Expenses, Taxes, Licenses, and Fees.* The auditing procedures for general expenses and taxes should be generally the same as those applied in other business enterprises except that the auditor should bear in mind that accruals for such items are usually not under general ledger control but are, in most cases, inventoried at financial statement date.

3.90 The auditor should make tests of the state coding for premium receipts to determine that premiums are being allocated to the proper state for premium tax purposes.

Chapter 4

Investment Operations

4.01 The investment operations of a life insurance company, while physically distinct, are an inseparable part of the life insurance concept and the overall operations.

4.02 Premium rates are determined with the assumption that premiums less current costs will be invested and will produce an estimated yield.

4.03 In the statutory statement of operations, investment income is reported net of related expenses, taxes, and depreciation.

4.04 Insurance statutes regulate the investments of insurance companies by giving the supervisory authorities the power to designate what types of investments may be acquired or held. State insurance laws prescribe the types of bonds, stocks, and mortgages which may be acquired by the companies, as well as the limitations on amounts of specific investments and aggregate costs of investments.

4.05 Investments of life insurance companies generally consist of bonds, mortgage loans, stocks, real estate, collateral loans, and policy loans; such investments are valued for regulatory reporting purposes at prescribed values which can generally be described within the following designations:

Bonds

4.06 Investments in bonds are generally made with the intention of holding the securities until maturity; therefore, bonds are usually carried at original cost reduced by amortization of premiums or increased by accrual for discounts. However, if a bond is in default as to principal or interest, values published by the NAIC must be used. Amortization is usually calculated by either (1) the straight-line method or (2) the level-yield method required by many states. In the case of bonds purchased at a premium which are subject to call before maturity, the premium is usually amortized to the call date.

4.07 Amortization of the premiums and accrual of the discounts are recorded as adjustments of interest income of the period.

Mortgage Loans

4.08 Mortgage loans are usually valued at their unpaid balances (or at amortized value if acquired at a value other than par). Such mortgage loans are considered admitted assets only if they are first liens. Second liens may be considered as admitted assets if the company also holds the first lien. The original amount of each mortgage loan is limited to a percentage (varying from state to state) of the appraised value of the underlying property.

Stocks

4.09 Investments in stocks are reported at values published by the NAIC. Common stocks are generally reported at market quotations. Preferred stocks in good standing, as determined by the NAIC, are reported at cost or, if held at December 31, 1964, the company has the option to value at association value as of that date. Preferred stocks not in good standing are valued at market.

4.10 Stocks of subsidiary, controlled, or affiliated companies are reported at values approved by the state (upon recommendation by the NAIC) on an individual basis.

Real Estate

4.11 Real estate properties may include those occupied by the company, those held for investment, and those acquired by foreclosure.* These assets are usually carried net of any encumbrances at the lower of cost (less accumulated depreciation) or market value. Some states will permit or require certain real estate to be carried at appraised values.

Collateral Loans

4.12 Occasionally, life insurance companies make collateral loans. The collateral securing the loans usually must be such that it would be an admissible asset if owned by the insurance company. The original amount of such loans is usually restricted to a percentage of the value of the collateral.

Policy Loans

4.13 Life insurance companies generally must permit borrowing against the cash values of policies. Policy loans are carried at their unpaid balances including accumulated interest but not in excess of cash surrender values or in excess of policy reserves. Many policy contracts require the company to initiate an "automatic premium loan" to pay delinquent premiums.

Other Investments

4.14 Other investment assets may include premium notes, certificates of deposit, accruals for interest, dividends, rent, and other investments permitted by law. The accruals may include dividends on preferred stocks or on common stocks payable on or before the balance sheet date but which were not received; dividends payable on common or preferred stock in the subsequent period are included in the accrual if the stock was being quoted ex-dividend at year end.

4.15 The excess of admitted asset value of investments over book value and interest, dividends and real estate income due and accrued are usually not recorded on the general ledger and, accordingly, are reported as non-ledger assets.

Outline of Auditing Procedures

4.16 The principal objectives in the audit of investments are to determine existence, ownership, the legality of the investment, the basis of valuation and the accounting for related income and gains and losses. Schedules A, C, and D of the annual statement provide a detailed listing of real estate, collateral loans, and bonds and stocks, respectively, at the end of the year, as well as details concerning acquisitions and disposals during the year, and income on individual investments. These schedules, or their underlying details, may be useful in the audit tests for investments.

4.17 The legality and admissibility of investment holdings should be tested by reference to applicable state laws and the NAIC valuation book. Securities owned, including securities held as collateral, should be inspected or confirmed with custodians or other holders as of the audit date. Tests should be made of the amortization of bond premium or discount. Consideration should be given to the need for a valuation allowance if collection of bonds at par is

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* SOP 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. SOP 92-3 should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992 and is included as Appendix K of this guide.

questionable. Committee minutes authorizing transactions should be examined.

4.18 Mortgage loans should be confirmed with mortgagors and, in some cases, with mortgage servicing agents. Underlying documents such as mortgages, deeds, and insurance policies should be examined on a test basis. The auditor may obtain audited financial statements of the servicing agents or some other appropriate evidence of the agents' financial condition. The existence of escrow funds for taxes and insurance should be determined. There should be some evidence that the servicing agent is adequately bonded and has adequate insurance protection. For new mortgage loans, appraisal reports should be examined on a test basis to assure the auditor that mortgage limitations have not been exceeded.

4.19 The valuations for stocks may be compared with quotations listed in financial publications. The method of determining valuations for stocks of other insurance companies and for subsidiaries should be reviewed, and it should be determined that the value is approved by the state.

4.20 The audit of investments in real estate involves the application of the usual steps associated with fixed assets.

4.21 Security transactions and interest and dividend income should be appropriately tested. Significant outside income from real estate investments should be tested by reference to source data.

4.22 Policy loans should be confirmed on a test basis; the interest should be compared to rates prescribed by the policy and the related income tested. The test should include a check that unpaid interest on policy loans is added to principal. A comparison of the policy loan including unpaid interest, if any, and the related cash surrender value for selected policies should be made to ascertain that the loan amount has not exceeded the related surrender value. As a practical matter, comparison with the related policy reserve could be acceptable for this purpose. Formal notes on file, if any, may be examined on a test basis.

Chapter 5

Other Assets

5.01 Other assets may include some or all of the following:

1. Life insurance premiums and annuity considerations deferred and uncollected.
2. Accident and health premiums due and unpaid.
3. Amounts recoverable from reinsurers.
4. Miscellaneous admitted assets.
5. Nonadmitted assets.

Life Insurance Premiums and Annuity Considerations Deferred and Uncollected

5.02 The category includes uncollected premiums on life insurance policies still in the grace period; these represent premiums due as of the current statement date. It may also include uncollected premiums on policies up to 60 or even 90 days beyond the grace period where the company has not yet processed the policy and removed it from the premium-paying in-force file. Most insurers delay the processing of lapses 60 to 90 days beyond the grace period because of the frequency of reinstatements during this period.

5.03 In addition, this category includes deferred premiums which result from the assumption, generally made in the calculation of statutory life reserves, that all premiums are paid annually on the anniversary date of the policy. Since many premiums are, in fact, paid on a monthly, quarterly, or semiannual basis, a calculation must be made to arrive at an amount to compensate for the annual mode assumption used in calculating the reserves. The amount of gross premiums to be used in arriving at the deferred premium amount can be determined by reviewing each premium-paying policy in force and (a) determining the anniversary date of the policy, the mode of premium payment, the date to which the premium is paid and whether it is a first-year or renewal premium; and (b) adding the gross amounts of such premiums that become due between the paid-to date and the next anniversary date of the policies.

5.04 After the total gross deferred and uncollected premiums are determined, a calculation is made to reduce such premiums from "gross" to "net." Gross premiums are the amount of premium paid by policyholders. Net premiums are the hypothetical premiums involved in the statutory policy reserve calculations. In many cases, net valuation premiums are listed in published actuarial tables.

Accident and Health Premiums Due and Unpaid

5.05 This item is identical in nature to uncollected premiums on life insurance policies previously discussed. However, for accident and health (A & H), with the exception of certain premiums due from ceding reinsurers, only those uncollected premiums due within three months of the reporting date may be included as an asset. Where premiums are payable more frequently than quarterly, only one premium may be included as an asset. So that profit will not be anticipated on the uncollected A & H premiums, a calculation is made to estimate the amount of commissions and other expenses that will have to be paid if the premiums are collected. This estimated amount is recorded as a liability.

Amounts Recoverable From Reinsurers

5.06 Amounts recoverable from reinsurers, which are carried as an asset, represent recoveries due from reinsurers on paid losses on life and accident and health insurance. Similarly, amounts recoverable on unpaid losses are deducted from the applicable claim reserve in the liability section of the statement of condition.

Miscellaneous Admitted Assets

5.07 Miscellaneous admitted assets may include investment in electronic data processing equipment (EDP), certain types of furniture and fixtures (dependent upon state regulations), bills receivable, and net foreign exchange adjustment.

Nonadmitted Assets

5.08 Nonadmitted assets include all assets other than those permitted to be reported as admitted assets in the annual statement. The principal nonadmitted assets are the following:

- Agents' debit balances.
- Furniture and equipment (except EDP equipment).
- Automobiles.
- Advances to officers and employees.
- Accrued income on investments in default.
- Excess of amounts loaned over stipulated percentages of related collateral.
- Prepaid and deferred expenses.
- Goodwill and similar intangible assets.
- In a few states, amounts recoverable from unauthorized reinsurers, unless covered by amounts due to such reinsurers. (In other states, a separate liability is required to be established for such amounts.)
- Excess of book value over admitted asset value of stocks and other investments.

5.09 Most of the preceding nonadmitted assets are self-explanatory. In general, receivables, other than those due from policyholders, should be classified as nonadmitted assets unless they are collateralized. Companies maintaining accounts for furniture and other equipment, and charging operations with depreciation are generally required to treat undepreciated balances as nonadmitted assets; however, some states permit furniture and equipment to be treated as admitted assets in amounts up to stipulated percentages of the aggregate of all other assets.

5.10 Unauthorized investments and investments in excess of amounts authorized by statute are nonadmitted. In many states, insurance companies are not permitted to own their own stock; loans collateralized by such stock are also classified as nonadmitted assets.

5.11 The cost of blocks of insurance in force purchased is usually charged off when incurred. Some states may permit such an item to be capitalized and amortized. The unamortized cost of such a purchase is, however, nonadmitted.

Separate Account Assets

5.12 Separate account assets and liabilities are found in the annual statement and represent summary totals of details contained in the separate account association blank. Separate accounts constitute a separate record of fiduciary responsibility for the assets which fund the liability to variable or fixed-benefit annuity contractholders, pension funds, and others.

5.13 Assets usually consist of stocks, bonds, cash, dividends receivable, and amounts due from brokers. Investments of variable annuity accounts are valued at market values.

5.14 The annuity considerations received by the separate account usually are net of charges levied on gross dollars received by the life insurance company. The amounts retained by the life insurance company are usually to pay commissions, premium taxes, and underwriting costs. In addition to annuity considerations, income is derived from dividends, interest, and capital gains and losses. Charges against income usually take the form of investment advisory fees, service charges, increases in reserves, and annuity benefit payments.

Outline of Auditing Procedures

5.15 *Life Insurance Premiums and Annuity Considerations Deferred and Uncollected.* Audit procedures relating to life insurance premium and annuity considerations deferred and uncollected should include tests to determine that

1. Policies listed as having uncollected premiums are in force and the premium is actually due.
2. Amounts included in the deferred premium tabulation apply to policies in force and the data are correct with regard to gross premium, mode, anniversary date, and whether first year or renewal.
3. Annualization of gross premium by mode compares to premium income for the period.
4. Policies included in the deferred computations are also included in the actuarial reserve computations.
5. Factors used to reduce the gross premium to net are appropriate. For renewal premiums, comparison of such factors can be made with those in previous years.
6. Net premium factors are consistent with the reserve assumptions; most accountants will need to utilize the services of a qualified actuary for this audit procedure. (See paragraphs 9.08 through 9.15, "Utilization of Actuaries.")

5.16 *Accident and Health Premiums Due and Unpaid.* Determine by a test basis that the listed premiums are uncollected and that the related policies are in force.

5.17 *Amounts Recoverable From Reinsurers.* Audit procedures for amounts recoverable from reinsurers include confirmation of amounts due and verification of subsequent collection as well as testing of selected claim payments to ascertain whether or not reinsurance applies.

5.18 *Miscellaneous Admitted Assets and Nonadmitted Assets.* The auditing procedures for assets in these classifications will be dependent upon the nature of the assets. The auditing procedures will be similar to those utilized in the performance of an audit of any other type of business. The auditing procedures would include confirmation, calculation, examination, and any other procedure that should be applied to satisfy the auditor.

5.19 *Separate Account Assets.* Since separate account assets consist principally of investments, the auditing procedures to be applied will be similar to those used for other investment accounts.

Chapter 6

Liabilities

Aggregate Reserve for Life Policies and Contracts

6.01 The aggregate reserve for life policies and contracts is an amount which is considered adequate to provide future guaranteed benefits as they become payable under the provisions of the insurance policies in force. The policy reserve is the aggregate result of an actuarial computation on each policy or group of policies. Theoretically, the policy reserve represents the present value of future guaranteed benefits reduced by the present value of future net premiums.

6.02 There are several policy reserving methods currently in use; the most common are the "net level" and "modified or preliminary term" methods. Under the net level method, the valuation net premium is a level percentage of the gross premium. The modified or preliminary term method provides a smaller increment to reserves in the first year to offset some of the higher first-year expense on a policy.

6.03 The two most significant factors in determining the policy reserves are the mortality and interest rate assumptions. Published reserve factors, based on various interest rates and mortality tables, are available for most plans of insurance. Aggregate reserves must at least equal those which would be determined according to the statutory minimum standard, which is expressed in terms of mortality tables and maximum interest rates. Given the plan of insurance, age of the insured at issue, and the date of issue, it is often possible to go to published tables for the appropriate reserve factors. Where such tables are not available, alternative procedures will be required. In any event, the auditor should satisfy himself that the life insurance reserves are fairly presented. A broad outline of auditing procedures to be followed in the audit of policy reserves is described below.

6.04 In addition to the basic reserves for future death benefits, the aggregate reserve for life policies usually includes amounts applicable to other contract benefits such as disability waiver of premium, disability income benefits, and additional accidental death benefits. The factors to be used for computing the policy reserves for these benefits may be incorporated in the basic published table used by the company or in separate published tables.

6.05 The aggregate reserve for life policies and contracts will also include annuities and supplemental contracts with life contingencies. As with life contracts, the policy reserves are determined by the use of approved, applicable tables.

6.06 The aggregate reserve for life policies is presented net of reserves ceded under reinsurance arrangements.

6.07 The liability for supplementary contracts without life contingencies and dividend accumulations is reflected separately in the annual statement and represents the present value of amounts not yet paid to beneficiaries or policyowners.

6.08 *Outline of Auditing Procedures.* Since the "inventory" of insurance policies in force is not under general ledger control, careful consideration of the internal control structure policies and procedures over the inventory is essential. Such a review should highlight the kind of errors more likely to occur so that the auditor can then direct his attention to those areas.

6.09 The audit tests necessary to satisfy the auditor that the aggregate reserve is a fair presentation of the company's life reserve liabilities can be divided into three main areas:

1. The inventory of policies in force must be tested for the inclusion and exclusion of all applicable policies and for the accuracy and completeness of the information included for each policy (i.e., plan, year, age, sex, policy riders, etc.).
2. The propriety of the actuarial factors used in computing the reserve must be examined.
3. The determination that the factors in step 2 have been correctly applied to the inventory of policies in force and the results have been accurately accumulated.

6.10 In smaller companies, the auditor can often obtain a detailed list of all the insurance policies in force. In larger companies, or in smaller companies where this listing is not available, the auditor must be able to obtain details supporting the accumulation of selected blocks or cells in the client's inventory.

6.11 After the auditor has obtained sufficient details of insurance policies in force, he should test the data to and from sources independent of the inventory such as cash receipts, the billing file, and the policy register to satisfy himself that all policies have been included in the inventory that should be included. He should also test to and from the lapse file, the claim register, and cash disbursements to assure himself that the proper deletions have been made to the in-force or inventory file. The auditor should also select items from the inventory in-force records of the prior year, or apply alternative procedures to satisfy himself as to the propriety of additions or deletions. The auditor should also perform tests to satisfy himself that the paid up policies (e.g., 10- and 20-pay policies on which no further premiums are being collected) are still included in the insurance in force and that the cutoff for the company's inventory of policies in force is consistent with the cutoff for the premium collections. The accuracy of coding shown on the detail of the insurance in force should be tested by comparing such coding with data shown on the original policy applications for which premium calculations have been tested by comparison with appropriate rate books. All of the aforementioned tests may be performed on the basis of statistical sampling techniques.

6.12 The determination that the factors have been correctly applied can be performed in the same way as any other test of clerical accuracy.

6.13 For policies in force in the prior year, a comparison should be made of the current factors and tables to the factors and tables used in the prior year.

6.14 Auditors will need to utilize the services of a qualified actuary for certain of the foregoing audit procedures. (See paragraphs 9.08 through 9.15, "Utilization of Actuaries.")

Aggregate Reserve for Accident and Health Policies

6.15 The aggregate reserve for accident and health policies consists of the (a) "active life reserve" which is that portion of due and collected premiums which has been set aside to be recognized as earned in the future and which includes the unearned portion of the current premium, "additional" reserves and reserves for rate credits, and (b) "claim reserves" which consist primarily of the present value of amounts not yet due on claims. Provision is made in both the active life and claim sections for a reserve for future contingent benefits.

6.16 The unearned portion of the current premium is computed for most types of accident and health coverages on a pro rata basis using either actual due dates and premium modes or one-half of the last modal premium. That portion of the unearned premium reserve applicable to credit A & H business is generally computed on the pro rata basis or the sum-of-the-years' digits method.

6.17 "Additional" reserves apply to policies which provide for the payment of level premiums for a risk the cost of which increases with the age of the insured. The reserve is similar in principle to the reserve on life insurance policies, with the further need to take into account the appropriate morbidity assumption.

6.18 Many accident and health policies provide for a "deferred maternity benefit" whereby medical expenses incurred in childbirth are covered for approximately nine months after the cessation of premium payments. The reserve for future contingent benefits represents current premiums set aside for such coverage and is generally equal to maternity benefits paid over the most recent nine months and adjusted for increases in business and claim cost. Provision for other future contingent benefits might be included.

6.19 The present value of amounts not yet due relates to that portion of the liability for claims incurred on or before the valuation date which has not been accrued as of the valuation date. The reserves are usually computed by the application of actuarially determined factors based on mortality, morbidity, interest, and policy limitations. Also included are reserves for unaccrued benefits on incurred but unreported claims.

6.20 *Outline of Auditing Procedures.* Unearned premium reserves and additional reserves are computed from inventories of accident and health policies in force which, like life policies, are not under general ledger control. Therefore, the consideration of internal control structure policies and procedures and audit testing described under the heading, "Aggregate Reserve for Life Policies and Contracts" are virtually the same for these liabilities.

6.21 Likewise, the reserves for present value of amounts not yet due on claims and future contingent benefits are akin to reported and incurred but not reported claim liabilities, respectively. See "Policy and Contract Claims," below for a discussion of appropriate auditing procedures.

Policy and Contract Claims

6.22 This liability represents amounts due on life and accident and health claims that have accrued as of the statement date but have not yet been paid. Included are accrued benefits on incurred but unreported claims. The liability is reduced by that portion of the policy and contract claims which is recoverable from reinsurers.

6.23 *Outline of Auditing Procedures.* The portion of the policy and contract claim liability that has been reported at the statement date can be verified by (1) comparing the items the client has included in the liability to the claim register, (2) reviewing claim disbursements subsequent to the statement date, and (3) reviewing the claims files and year-end cutoff procedures.

6.24 The adequacy of the incurred but not reported portion of the liability can be reviewed by an examination of the claim register through the latest date available, extracting those claims that have an incurred date before the statement date, but a reported date after the statement date. In this connection, it should be recognized that the lag between incurred dates and reported dates is a critical factor in determining the adequacy of these reserves. The total of these claims should then be compared to the amount provided for incurred but not reported claims at the statement date. It should be noted, however, that in most cases all the claims will not have been received at the date the audit is completed; therefore, the auditor must analyze the past years' experience and project it to the future after considering various modifying factors, such as premium volume and claim frequency and severity. A development through the current date of the prior years' incurred but not reported reserves can be of great assistance to the auditor in this projection. Also, the assistance of a qualified actuary will usually be required. (See paragraphs 9.08 through 9.15, "Utilization of Actuaries.")

Dividends to Policyholders on Participating Policies

6.25 Participating policies generally provide for the payment of annual dividends after the policy has been in force for two or three policy years. Annual dividends are generally payable on policy anniversaries. The board resolution authorizing the payment of dividends is usually made annually for policies reaching policy anniversaries within a certain calendar period. The amount apportioned for distribution to policyholders as annual dividends is commonly called "divisible surplus" and represents the excess of the funds on hand over the amount which the company determines it should hold to meet future needs. The company must determine that the level of its surplus and other company goals can be satisfied before determining the final amount of divisible surplus. Some companies also pay termination dividends. Such dividends may be payable when a policy terminates by maturity, surrender, or death. Termination dividends are paid from the funds which have been accumulated in excess of the reserve or cash value and which are released upon termination of the policy.

6.26 Annual dividends on individual policies are generally determined from formulas based on the classic contribution method, asset share method, experience premium method, or fund method. These methods are designed to provide a basis whereby a company's divisible surplus may be prorated to the various classifications of individual policies in proportion to the net total contributions to surplus arising from actual experience as compared to assumed mortality, interest, withdrawals, expense, and sometimes other factors such as provision for experience fluctuations or abnormal costs. Capital gains or losses may be considered in the determination of divisible surplus and in the dividend formulas, usually through an adjustment in the interest factor. Techniques based on experience are also used in calculating dividends for health insurance and group insurance.

6.27 A legal consideration may affect the aggregate amount of distribution. For example, in Illinois no more than 10% of the profit on participating business issued by a stock company can inure to the benefit of the shareholders. New York State has, in addition to restrictions on earnings from participating business, maximum and minimum surplus requirements, depending upon when a company was organized.

6.28 Dividends can be (1) paid in cash, (2) applied to pay premiums, (3) applied to provide paid-up additions, (4) applied to shorten the endowment or premium-paying period, or (5) left on deposit. Items (3) and (4) are reserved for directly in the policy reserves, while item (5) is included as a part of the liability for supplementary contracts without life contingencies and dividend accumulations. There are a number of other dividend options available.

6.29 The aggregate dividends must be approved by the board of directors, and the dividend must be formally declared before any legal liability exists. When declared, the liability for dividends must be recorded for the amount so declared.

6.30 The liability for dividends due and unpaid refers to dividends payable prior to the end of the accounting period but not yet paid. As a separate item, a liability is established for dividends payable beyond the end of the accounting period if a commitment to pay such dividends has been made by board resolution. Some states require a life company to set up a liability for a full year's dividends whether or not they have been declared.

6.31 *Outline of Auditing Procedures.* The procedures followed in determining the amount of policyholders' dividends should be reviewed for reasonableness and for compliance with policy terms and/or statutory requirements. The factors involved should be compared to other audited data and calculations should be tested. Auditors will need to utilize the services of a qualified actuary for these audit procedures. (See paragraphs 9.08 through 9.15, "Utilization of Actuaries.")

6.32 The recording of dividends among cash payments, dividends accumulated at interest, dividends applied against premiums, and dividends applied to provide additional paid-up insurance should be tested. If not tested as a part of cash disbursements, dividend payments should be tested separately. Consideration should also be given to confirming dividends directly with policyholders.

6.33 The minutes of the board of directors' meeting should be reviewed to ascertain their approval of the dividend declarations.

Premiums Paid in Advance and Premium Deposit Funds

6.34 Life insurance premiums and annuity considerations paid in advance represent, for the most part, premiums paid for one or more years in advance which are discounted at a guaranteed interest rate to the specified due date and which are recorded as liabilities (sometimes classified as premium deposit funds) and recognized as income as they become due. Premium deposit funds are often recorded as ledger liabilities. Premiums paid immediately in advance of the next anniversary, without discount, are initially recorded as premium income but income for which a liability (classified as advance premiums) must be established with a corresponding reduction of premium income. Such liability is established by estimate or by inventory. Accident and health premiums paid in advance are similarly treated, but there usually is no discount associated with such premiums.

6.35 The payment of premiums in advance is encouraged by most life insurance companies because of the greater probability of higher persistency of policies for which premiums have been paid for a period well into the future.

6.36 Premium deposit funds are accounted for so that premiums are credited to income when due and interest is credited annually to the deposit account.

6.37 *Outline of Auditing Procedures.* Receipt of premiums paid in advance and premium deposit funds should be tested. Calculations of discount, interest, and premiums charged against the liabilities should also be verified by test. Consideration should be given to confirming balances directly with policyholders.

6.38 Advance premiums established by estimate or by inventory should be reviewed and tested as appropriate. The basis for establishing unearned premiums for accident and health policies should also be reviewed and tested.

Other Reserves

6.39 In addition to the reserve and liability items already mentioned, there may be miscellaneous reserves or liabilities which should be provided. Life insurance companies may voluntarily provide such reserves, or state insurance departments, upon examination, may also require them.

6.40 It is possible that reserves, based on the usual mortality or morbidity tables may not encompass all benefits so that special reserves may be required. For example, special retirement options may require reserves beyond those in the insurance or annuity section of the regular reserves. Reserves might also be required for extra mortality after conversion of term insurance.

6.41 Another miscellaneous reserve item might be required for accident and health policies which, while not guaranteed renewable or noncancellable, may be administered in such a way as to be very similar to policies with such renewability clauses. In such cases companies have, voluntarily or upon request of insurance departments, provided an additional reserve on policies which are described as "nonrenewable for stated reasons only."

6.42 A liability may also need to be established in respect of the extra costs of future supplementary contracts arising from overly liberal settlement option provisions in outstanding policies.

6.43 *Outline of Auditing Procedures.* The auditor should review all miscellaneous reserves for propriety. The basis for these reserves should be determined and appropriate tests made of their calculation.

6.44 Most auditors will need to utilize the services of a qualified actuary for these audit procedures. (See paragraphs 9.08 through 9.15, "Utilization of Actuaries.")

Other Liabilities

6.45 Other liabilities consist of accrued expenses, taxes, licenses, and fees, as well as the following items peculiar to the insurance industry:

- *Commissions to agents due or accrued* are applicable to premiums which have been collected but for which the applicable commissions have not been paid.
- *Amounts withheld or retained by the company as agent or trustee* include payroll withholdings and amounts held for payment of taxes and insurance under mortgage loans.
- *Amounts held for agents* generally represent credit balances in agents' accounts.
- *Remittances and items not allocated* are premium cash clearing accounts and other suspense accounts.

6.46 *Outline of Auditing Procedures*

1. *Accrued expenses*—tests should be made to determine that all liabilities are properly included at the close of the year in the annual statement. The auditor should test the calculations of those accruals that lend themselves to such treatment; other accruals should be reviewed as to reasonableness and the consistency of their development.

2. *Taxes, licenses, and fees*—tax returns should be examined on a test basis in support of payments and adequacy of accruals for the various state taxes and sufficient tests made to determine that the taxes have been properly calculated and the allocable credits taken.

3. *Commissions*—contracts should be reviewed to determine that proper rates were used. Calculations should be tested. The auditor should determine that the commission cutoff is consistent with that of premium income.

4. *Amounts withheld*—the auditor should review support for items in this account and verify by confirmation, recalculation, or subsequent payment review.

5. *Amounts held for agents*—this account should be tested in connection with tests of balances due from agents.

6. *Remittances not allocated*—the auditor should review an aging of this account and investigate old, large, or unusual items by references to supporting data.

Federal Income Taxes*

6.47 Life insurance companies are taxed under the Life Insurance Company Income Tax Act of 1959. In some of its provisions, the Act gives recognition to the uncertainty of the determination of period income because of the long-term nature of the life insurance contract by allowing deferral of taxation on a portion of the apparent income until the untaxed amount is identified as income by payment of dividends to shareholders or by other action which attributes the amount to shareholders. See Appendix C.

6.48 *Outline of Auditing Procedures.* The auditor should analyze the liability account for the year and vouch payments to copies of the tax return. The most recent revenue agent's report should be reviewed and the current status of any revenue agent's examination in process should be discussed with the clients. Provision for federal income tax for the current year should be recalculated. The auditor should review the accrual and also those returns that have not been examined but are not closed by the statute of limitations.

Mandatory Securities Valuation Reserve

6.49 The mandatory securities valuation reserve is reported as a statutory liability. One of the effects of the statutory reserve is to stabilize the statutory surplus of the company against fluctuations in the market value of securities. Another effect is to provide, on a formula basis, for a valuation allowance against collection of bonds at par.

6.50 The reserve is developed through annual charges to surplus equal to formula percentages of admitted asset security values at the end of the year, and realized and unrealized capital gains during the year; the reserve is reduced by all realized and unrealized capital losses. The reserve development is generally structured to reach its maximum amount, with respect to a particular security, at the end of 20 years (longer in the case of the common stock component) exclusive of the effect of capital gains and losses.

6.51 *Outline of Auditing Procedures.* The auditor should obtain a copy of the NAIC form used for calculation of the mandatory securities valuation reserve and read the applicable instructions and ascertain that the company is complying therewith. The company's classification of the securities in the

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* There have been several rather significant revisions to taxation of life insurance companies since this guide was first issued. Current discussion of federal income taxes will be provided in a future revision.

reserve classifications should be tested by the auditor and calculations should be rechecked on a test basis.

Separate Account Liabilities

6.52 Separate account liabilities usually consist of reserves for variable annuity contractholders, amounts due the investment adviser and administrator (the life insurance company), and amounts due brokers. (See paragraph 5.19, "Separate Account Assets.")

Chapter 7

Capital and Surplus

7.01 Capital and surplus of a life insurance company consists of capital stock, paid-in or contributed surplus, special surplus funds, and unassigned surplus. Special surplus refers to amounts of unassigned surplus set aside to provide for contingencies, such as mortality fluctuation reserves and group contingency reserves.

7.02 In the case of stock companies, the amount of capital stock required to be issued and maintained is governed by the respective state insurance laws. The law usually prescribes the minimum value of the shares that may be issued. In addition to the minimum capital stock requirements, there is usually a provision for the payment of an additional amount, in the form of surplus, equivalent to a prescribed percentage of the minimum capital stock. Some state laws permit dividends to be paid out of surplus regardless of the source as long as the minimum statutory surplus amount is maintained.

7.03 In lieu of capital stock, mutual companies are organized with prescribed minimum surplus which varies among states. Such surplus may take the form of guaranty funds, guaranty capital, or other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

7.04 In addition to the gain or loss from operations and dividends paid, surplus transactions include the following, which are peculiar to the insurance industry.

Net Unrealized and Realized Capital Gains or Losses

7.05 Unrealized capital gains or losses originate as a result of the prescribed method of valuation of investments. The change in the difference between book value and prescribed value occurring between reporting dates is credited or charged to surplus as unrealized capital gains or losses.

7.06 Realized capital gains or losses from sale or other disposition of investments in the reporting period, net of applicable federal income taxes, are also credited or charged to surplus. In current industry practice, realized gains and losses are charged to income in the statutory blank.

7.07 Changes in assets and liabilities during the year due to the change in foreign exchange rates are also included in the net unrealized and realized capital gains or losses.

Changes in Nonadmitted Assets

7.08 As previously discussed, certain assets are excluded from the balance sheet when reporting to the regulatory authorities. The net change between such nonadmitted amounts during the year is charged or credited to surplus.

Change in Mandatory Securities Valuation Reserve

7.09 Any increase or decrease in the amount of the mandatory securities valuation reserve between reporting dates is charged or credited to surplus.

Change in Reserve on Account of Change in Valuation Basis

7.10 The company may strengthen (or decrease) its policy reserves by changing its actuarial assumptions. A change to the net level basis from the preliminary term basis or a lowering of the interest assumption will result in a larger reserve requirement. The surplus account is charged for the amount necessary to bring reserves accumulated in prior years to the requirements under the new assumptions.

7.11 There may be other surplus transactions in addition to those listed above.

Outline of Auditing Procedures

7.12 Except for the need to check the statutory minimum capital and surplus requirements applicable to the lines of business written by the company, the audit of capital and surplus is the same as that of other industries.

7.13 In view of the tendency to accumulate all types of surplus in one account, it is frequently necessary to analyze the account to determine the sources of surplus. The applicable state laws should be reviewed to ascertain compliance with restrictions on surplus, and the validity and propriety of any miscellaneous surplus items should be ascertained.

PART II

Application of Generally Accepted Accounting Principles

Chapter 8

Principles of Accounting

8.01 Many life insurance contracts provide for the performance of services which may extend a generation or more into the future. The financial results of any specified group of policies cannot be known with certainty until the contracts have been terminated or have matured. The results reported for any accounting period are highly dependent upon actuarial assumptions involving estimates of future developments with respect to mortality, investment yield, expenses, and withdrawals and upon the variance from these estimates. While such estimates are usually based on experience, each of these elements has had periods of adverse experience in the past and there can be no assurance that estimates made for the future will, in fact, be realized.

8.02 The actuarial assumptions and estimates used in determining annual revenue and costs applicable to life insurance contracts are extremely significant and involve considerable judgment. Many accounting problems of a long-term nature such as accounting for pension costs, long-term leases, construction projects, depreciation, and amortization involve similar judgment, but accounting for life insurance contracts generally involves longer periods of time and substantially more material amounts than those encountered in similar judgments in other businesses.

8.03 Conservatism in valuing assets and liabilities and in accounting for revenue and costs is necessary because of the uncertainties inherent in the use of actuarial assumptions and estimates for contracts guaranteeing performance over long periods of time and the risk of unfavorable variations (adverse deviations) from such assumptions and estimates. However, as contemplated by generally accepted accounting principles, such conservatism must be reasonable and realistic.

8.04 The choice of actuarial assumptions and the disciplining of that choice are primary responsibilities of the actuarial profession. The related responsibility of the auditor is to form a judgment as to whether the actuary has been guided in his work by considerations which are consistent with generally accepted accounting principles. In this connection, it should be noted that the "Guides to Professional Conduct" published by the American Academy of Actuaries requires that "the member will exercise his best judgment to ensure that any calculations or recommendations made by him or under his direction are based on sufficient and reliable data, that any assumptions made are adequate and appropriate, and that the methods employed are consistent with the sound principles established by precedents or common usage within the profession."

8.05 At the time of publication of this audit guide, when the concept of generally accepted accounting principles as set forth in the guide has not yet been generally applied to the financial reporting of life insurance companies, there is a relative scarcity of published "precedents or common usage" to guide the actuarial profession in the choice of actuarial assumptions or the disciplining of the choices. The American Academy of Actuaries is examining these areas intensively and can be expected to provide more extensive guidance at an early date.

8.06 However, the actuary's choice of assumptions to be used in connection with general purpose financial statements is disciplined by the principles of his profession. His responsibility to use assumptions which are "adequate and appropriate" is consistent with the concept, under generally accepted accounting principles, that actuarial assumptions be characterized by conservatism which is "reasonable and realistic." The auditor should expect the actuary to be able to demonstrate that assumptions used in determining actuarial items in a general purpose financial statement meet such standards.

8.07 Under regulatory accounting practices, life insurance reserves are provided for death benefits and other similar contract benefits. Such reserves are actuarially computed and represent the present value of future benefits reduced by the present value of future premiums. Under regulatory accounting practices, the interest rate used for discounting is subject to statutory limitation and may not be representative of the company's expected investment yield. Regulatory reserves are also calculated without regard to the effect of withdrawals. In addition, under regulatory practices, expenses, including the cost of acquiring new business, are charged against income as incurred and dividends are provided as paid or accrued. Some regulatory reserving methods are designed to partially offset the effect of charging such expenses as incurred.

8.08 The interests of policyholders and of the public in the financial integrity of the life insurance industry make it important and proper that the solvency of life insurance companies be demonstrated to regulatory authorities. Consideration of these interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (regulatory accounting practices).[1] Solvency must be continuously demonstrated for a life insurance company to be permitted to offer its services to the public. Federal income taxation of life insurance companies is also based primarily on these insurance regulatory accounting practices. The use of generally accepted accounting principles, as discussed herein, should not be construed as an indication that such accounting principles should also be used in reporting to insurance regulatory or taxing authorities.

8.09 SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles,* paragraph 2 states that the basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to regulated companies, including insurance companies. Regulatory accounting practices differ in some respects from generally accepted accounting principles. The purpose of this chapter is to discuss the difference between these two bases, and to set forth appropriate guidelines for accounting and financial reporting in conformity with generally accepted accounting principles for general-purpose financial statements. The object of such statements is to provide reliable financial information about economic resources and obligations of a business enterprise and changes in net resources resulting from its business activities, measured as a going concern.

8.10 A summary of the major areas involving variances between regulatory accounting practices and generally accepted accounting principles is set forth below. Each of these areas is discussed later in this section:

Recognition of premium revenues

Recognition of costs

Loss recognition

Deferred income taxes

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[1] Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

Valuation of investments and recognition of realized and unrealized gains (losses) thereon

Investments in subsidiaries

Special reinsurance agreements

Commitment fees

Stockholders' equity

Mandatory Securities Valuation Reserve (MSVR)

Nonadmitted assets

8.11 It should be recognized that regulatory accounting practices may result in other variations from generally accepted accounting principles. These include, but are not limited to, (1) charging reserve "strengthening" directly to surplus rather than against income, (2) charging surplus rather than income with prior service costs of pension plans, (3) netting encumbrances against related assets and (4) transferring only the par value of stock to capital for certain stock dividends. Other adjustments or reclassifications may be required if they are material to the presentation of financial position or results of operations, in conformity with generally accepted accounting principles.

Recognition of Premium Revenues*

8.12 Premiums are designed to cover benefits expenses, and profits on the basis of assumptions with respect to mortality, investment yield, withdrawals, and expenses. Premiums received in anticipation of future benefits and expenses provide investable funds. The investment of such premiums is recognized in the actuarial assumptions and in setting the premiums.

8.13 The following alternatives for the timing of recognition of premium revenues for insurance contracts were considered:

1. At the completion of the contract.
2. At sale or issuance of the contract.
3. During the life of the contract.

It was concluded that premium revenues should be recognized over the life of the contract in proportion to performance under the contract; accordingly, the first two alternatives were rejected. In general, the Committee agreed that if performance could be measured by one or more of the predominant functions or services, premium revenues should be recognized in direct proportion to such functions or services or by some method which approximates the measure of such functions or services.

8.14 The following functions and services were considered as bases for recognizing premium revenues:

1. *Premium collection*—recognition of premiums as revenues under traditional statutory practices.
2. *Costs incurred*—recognition of premium revenues in proportion to costs incurred (acquisition costs, benefits, and expenses).
3. *Invested funds*—recognition of premium revenues in relation to projected investment funds.
4. *Net amount at risk*—recognition of premium revenues in proportion to

* FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* significantly impacts the recognition of premium revenues and loss recognition.

a. Gross amount at risk reduced for cash surrender values.

b. Net amount at risk weighted for probability of death.

5. *Insurance in force*—recognition of premium revenues in proportion to the amount of insurance in force.

Life and Endowment Contracts

8.15 *Whole-Life Contracts.* After consideration of the aforementioned bases, it was concluded that there was no predominant function or service which provided a measure of the composite of all functions and services with respect to whole life contracts; therefore, a level recognition of premium revenue over the lives of individual contracts was considered an appropriate method of recognition of revenues in proportion to performance. This level recognition of premium revenues for whole-life contracts is satisfactorily accomplished by recognizing premiums as revenues when due. It should be noted, however, that such revenue recognition does not necessarily result in a level profit recognition for the reasons discussed below.

8.16 It has been suggested that life insurance is a risk undertaking as opposed to a service function. The Committee concluded that the risk undertaking of a life insurance company consists of the pooling of individual risks under which the principal risk is that actual experience will be more adverse than the basic assumptions underlying premium rates. Such assumptions have been referred to as "most realistic," "best estimate," or "expected value" rates as to mortality, interest, withdrawal, and expense. In each accounting period, a company realizes actual experience with respect to these assumptions; in the process, a portion of the risk of adverse experience is removed. The process of assuming these risks and gradually being relieved from such risks represents an essential function or service performed by a life insurance company. The risks of adverse deviations from which the company is relieved during an accounting period, therefore, constitute an important measure of performance that should be recognized in determining the timing of the recognition of premium revenues and related costs. The inclusion of a provision for the risk of adverse deviations in arriving at reasonably conservative assumptions will cause some profits to emerge over the life of the contract as risks are eliminated in that

1. In the absence of adverse deviations in mortality, some profits will emerge in relation to the net amount at risk.
2. In the absence of adverse deviations in the investment yield, some profits will emerge in relation to invested funds or investment income.
3. In the absence of adverse deviations in withdrawal rates, some profits will emerge in relation to the excess of (a) the difference between the benefit reserve less unamortized acquisition expenses over (b) the related cash value.
4. In the absence of adverse deviations in estimated expenses, some profits will emerge in relation to expenses incurred.
5. Any profit in the premium in excess of provisions for adverse deviation will emerge in relation to premium revenues. Profits emerging as a level percentage of premiums give recognition to the importance of the sales effort as a source of profit. Margins allocated to this function, however, must not be at the expense of providing for the risk of adverse deviations in the mortality, investment yield, withdrawal, and expense assumptions.

8.17 *Limited Payment Contracts (Other Than Term Contracts).* As in the case of whole life contracts, revenues should be recognized in relation to performance under the contract. The level of performance under limited payment contracts is significantly greater during the premium-paying period than after such period, since all the sale and conservation services necessary to establish and retain the pooling of individual risks, many of the investment services, and other services, such as revisions of coverage, are generally greater during the shorter premium-paying period. If, after providing for mortality, withdrawals, expenses (including higher maintenance expenses and amortization of acquisition costs during the premium-paying period), and the risk of adverse deviations (all based on assumed investment yield), there is any remaining gross premium in excess of the valuation premium, it is properly recognized over the premium-paying period in recognition of the higher level of services and functions performed during that period. Because of the provision for risk of adverse deviation from estimates of mortality, withdrawals, investment yield, and expenses over the life of the contract, this method should provide operating results that are both reasonable and conservative.

Term Contracts

8.18 A wide variety of term insurance contracts are issued. The clearly predominant service provided by many such term contracts is protection. Examples of term contracts where the predominant service is protection, include credit life insurance and other types of single or limited payment contracts of a relatively short duration. Gross premium revenues on such contracts should be recognized in proportion to the amounts of insurance in force. Expressed otherwise, written premiums should be recognized as earned during each year that a policy is in force in proportion to the ratio of the amount of insurance in force each year to the total of the annual amounts in force over the life of the policy.

8.19 In instances where premiums are collected throughout the life of the term contract and where the contract is of sufficient duration as to make it unclear as to the relative significance of the protection service as opposed to the sales, collection, investment and conservation services necessary to establish and retain the pooling of individual risks, it may be appropriate to recognize premium revenues in the same manner as previously discussed for whole-life insurance contracts. However, the risks of adverse deviation with respect to the mortality and withdrawal assumptions are more significant than is the case with whole-life contracts.

Annuity Contracts

8.20 The reasoning underlying the accounting described for recognition of premium revenue from whole-life and limited payment life insurance contracts also applies to annuity contracts; therefore, annuity considerations should be recognized as revenue when due.

Accident and Health Contracts (Health Insurance)

8.21 Accident and health contracts generally fall into three categories: (1) individual, (2) group, and (3) credit.

8.22 Key features of these contracts are as follows:

1. Individual Accident and Health
   a. Renewable at the option of the company (also referred to as cancellable)—premiums may be step-rate or level; but, for contracts which are expected to be renewed, rates are adjustable.

b. Collectively renewable—similar to (a) above but the company cannot cancel individual policies without cancelling all policies in the particular group or all like policies within a state.

c. Guaranteed renewable—renewable at the option of the insured for a specified period; premium rates are adjustable, typically only for all like policies within a state.

d. Noncancellable—same as guaranteed renewable except premium rate is guaranteed.

2. Group Accident and Health

Usually annual renewable term although companies may guarantee rates for two or three years; usually cannot be cancelled unless participation requirements are not met; experience rating provisions are common.

3. Credit Accident and Health (Group and Individual)

a. Single premium—term of the contract ranges from several months to several years. Maximum premium rates are stipulated by the states.

b. Monthly outstanding balance—similar to regular Group Accident and Health.

8.23 The accounting for accident and health insurance policies, which are expected to be in force for a reasonable period of time and for which elements of expense or benefit costs are not level, should follow the same principle of accounting as followed for whole-life insurance. Accordingly, premium revenues should be recognized over the premium-paying period. For other kinds of health insurance, gross premiums should be recognized as revenues on a pro rata basis over the period covered by the premium except in those cases of credit accident and health where the coverage decreases by passage of time. For the latter type contracts, gross premiums should be recognized as revenues over the stated period of the contract in reasonable relationship to the anticipated claims.

Recognition of Costs*

8.24 Having determined the manner in which premium revenue is to be recognized, it is necessary to consider the manner in which costs (benefits and expenses) should be associated with premium revenue. The association is dependent upon the assumptions and methods used in accounting for annual costs.

Life Insurance Other Than Short Duration Term Contracts

8.25 Annual charges for costs in conformity with generally accepted accounting principles should be determined using methods which include assumptions for interest, mortality, withdrawals, expenses, and other benefits. The cost of acquiring new business should be deferred and other non-level costs should be provided for in order to charge operations in proportion to premium revenue. The assumptions used, including provision for the risk of adverse deviation, must be reasonably conservative.

8.26 The basic assumptions and methods and considerations related thereto are discussed below.

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* FASB Statement No. 97 significantly impacts the recognition of premium revenues and loss recognition.

8.27 *Acquisition Expenses.* Regulatory accounting practices require that commissions and other expenses in connection with acquiring new business be charged against income as incurred. In many instances, commissions and other acquisition expenses will exceed related premiums during the initial year that policies are in force. In a period of increasing production, the results of operations are depressed because acquisition expenses are charged against income currently, whereas related premiums will be recognized as income in later years. Conversely, in a period of decreasing production, the results of operations are benefited by premiums being taken into income, whereas related acquisition expenses were charged against income in prior periods. Accordingly, acquisition expenses should be deferred and charged against income in proportion to premium revenues recognized. Reference is made to Appendix B for a discussion of the considerations involved in the method to be used for amortizing acquisition costs.

8.28 Only those acquisition expenses which both vary with, and are primarily related to, the production of new business should be deferred. These should include renewal commissions based on a descending commission scale even though such expenses are incurred subsequent to issue. The inclusion of any indirect expenses in acquisition expenses requires judgment on the part of both the company and the auditor with overriding considerations being those of reasonable conservatism, consistency, and recoverability.

8.29 Generally speaking, there are two broad types of acquisition expenses. The first is related to the actual sale of insurance, for example, commissions. The second is related to the processing of business submitted by agents and the setting up of the necessary records.

8.30 In some companies virtually all "sales" expense is composed of compensation paid to agents. Such compensation relates directly to the amount of business produced by an agent. In other companies considerably less compensation will be paid to agents; however, additional sums will be paid to salaried employees, such as to branch office managers and employees or to field representatives who call on and assist the agents. There are also companies that do not sell through agents. Some companies employ a salaried sales force. Other companies operate on the mail-order plan and, in order to acquire business, these companies incur costs for brochure design and printing, postage, advertising, and other direct solicitation expenses. Regardless of the method used by a particular company to sell insurance, an acquisition expense should be deferred only if the expense both varies with and is primarily related to the production of new business.

8.31 Issue, as opposed to sales, expenses are generally incurred in the home office of a company. In some companies, issue functions are partly performed in regional or branch offices. Issue costs which may be deferred are those expenses of the underwriting and policy issue departments which are primarily related to and vary with new business.

8.32 After determining whether an acquisition expense is to be deferred, it is usually necessary to allocate such expenses by line of business and by type of business (e.g. permanent and term) or by some other classification in order to associate them with the related premium revenue. These resulting factors for expenses should be measured against the expense assumptions used in setting premiums as a test of the reasonableness of the allocations.

8.33 Actual acquisition expenses, as distinguished from those assumed, should be used in the calculations as long as it can be shown that the gross premiums charged are sufficient to cover the actual expense. However, as a practical matter, most actuarial techniques require the use of estimates to calculate the amounts to be deferred. Such estimates are made before the costs are actually incurred. As in the case of variances from standard costs in other businesses, it may not be necessary to adjust such estimates to actual if they do not vary significantly from actual acquisition expenses.

8.34 Policy benefits and unrecovered acquisition costs may be accounted for by means of a single valuation reserve using factors expressed as amounts per thousand dollars of insurance in force. Such valuation represents the present value of all benefits and expenses related to policies in force reduced by the present value of that portion of gross premiums necessary to cover such benefits and expenses. Many assert that this single valuation reserve is also the most appropriate basis for financial statement presentation. Those who hold this view believe the interdependent relationship between benefits and expenses related to policies in force and the premiums expected on such policies require the net valuation reserve to be presented as a single amount in the balance sheet.

8.35 Policy benefits and unrecovered acquisition costs may also be accounted for separately. Many assert that such separate accounting is also the most appropriate basis for financial statement presentation. Those who hold this view believe that there is a significant difference in the nature of acquisition expenses already incurred, which must be recovered from the expense portion of future premiums, and the liability representing the benefit portion of premiums collected, which are being held to meet future benefits. They believe that this difference requires separate presentation of such amounts in the balance sheet.

8.36 Each method accomplishes a reasonable association of costs with related revenues and should produce the same net income and stockholders' equity.

8.37 The deferral and amortization of acquisition costs represents a significant change in accounting practices for life insurance companies. Such deferral and amortization will generally represent a substantial portion of the difference between stockholders' equity and net income presented in conformity with generally accepted accounting principles and such amounts presented in accordance with regulatory practices. The magnitude of deferred acquisition costs and their effect on reported earnings will be of significant interest to the users of life insurance company financial statements. In light of these facts, the Committee has concluded that, because of the magnitude of such amounts, complete disclosure requires their separate presentation and that, because of their nature, fair presentation requires classification of unamortized acquisition costs as a deferred charge.

8.38 *Other Expenses.* If an expenditure has substantial future utility, and is clearly associated with and recoverable from future revenue, it may be considered for separate deferral in line with practices followed in other industries. An example of such an expenditure might be computer systems costs. If separately deferred, the expense should be amortized in a systematic and rational manner.

8.39 Non-level expenses, such as termination or settlement expenses, and expenses after the premium-paying period must be provided during the premium-paying period.

8.40 A portion of a life insurance company's expenses, such as policy maintenance and general overhead, are not associated directly with acquiring new business nor are they appropriate for separate deferral. As in the case of other business enterprises, such expenses should be charged to operations in the period incurred. Therefore, level renewal expenses in the premium-paying period do not require a reserve to be provided, but the expense portion of the gross premium must be adequate to cover such expenses as well as deferred costs. In addition, all renewal expense assumptions should take into account the possible effect of inflation on these expenses.

8.41 *Interest (Return on Funds Invested).* The rate of interest used in an actuarial valuation is an expression of a composite yield rate assumed on the funds invested or to be invested to provide for the future benefits and expenses. Since in most instances the investments include equity securities and real estate as well as debt securities, the yield rate includes dividends, rental income and interest. Such yield rate should be net of investment expenses.

8.42 Actual yields will tend to significantly influence the interest assumption. The influence of actual yields on the interest assumptions will usually be reflected more frequently and more currently in the rates charged for insurance than is the case for the statutory maximum interest limitation, used for computing statutory reserves. Statutory interest assumptions are frequently lower than actual or expected yields. The use of such lower interest assumptions tends to defer the recognition of income. Over the lives of any specified group of policies, the total income earned is the same regardless of the interest assumption used for accounting purposes. However, the annual incidence of income recognition will vary with the assumptions used. The use of a low reserve interest assumption initially places a greater portion of the gross premium in the reserve annually than does the use of a higher assumption. Thus, the use of low reserve interest assumptions tends to reduce the amount of income that might otherwise be reported in the early policy years, while income in later policy years tends to be benefitted when high reserves are released upon death and surrender.

8.43 To the extent that the statutory interest assumptions differ significantly from the average yield rate that can be expected on the funds invested or to be invested, more realistic assumptions should be considered. The selection of such an interest assumption is a subjective judgment which must be made by the company in light of the long term nature of life insurance, the contractual obligations under life insurance policies, and the inherent inability to forecast the future with certainty.

8.44 The interest assumption for each block of new issues should not be inconsistent with such factors as actual yields, trends in yields, portfolio mix and maturities, and a company's overall investment experience generally. Since life insurance involves long-term obligations and investment risks, the assumed interest rate should include provision for the risk of adverse deviation from such estimates. Generally, the interest assumption to be used in computing reserves in conformity with generally accepted accounting principles should be based on the estimate of future interest expected at the time that the policies are issued.

8.45 To the extent that subsequent yields exceed the interest rate assumed in establishing policy reserves, such excess interest should be reported as income as it is earned. Periodically adjusting the reserve interest assumptions for in-force business to reflect changed conditions prospectively is not considered appropriate since the inherent fluctuations in investment yields make it impracticable to determine the proper timing and the extent to which such adjustments should be made.

8.46 *Mortality.* Minimum legal standards for statutory reserves are based on mortality tables prescribed by the various states as recommended by the National Association of Insurance Commissioners. At present, the minimum standard for reserves on ordinary issues is the Commissioner's 1958 Standard

Ordinary Table. Under regulatory accounting practices, no change can be made in the reserves for existing insurance in force which would cause the reserves to be less than the minimum standards in effect when the policies were issued.

8.47 The mortality assumption to be used in determining annual reserve additions in conformity with generally accepted accounting principles should be based on realistic estimates of expected mortality. As in the case of other estimates, provision for adverse deviations should be included. For any blocks of business which are subject to little or no underwriting selection, the use of ultimate-only or aggregate mortality tables will be appropriate. Where there is adequate medical underwriting, a select table should be used.

8.48 *Withdrawals.* Under regulatory accounting practices, no specific provision for the liability for withdrawals (terminations for reasons other than death or maturity) is required because cash surrender values or other nonforfeiture benefits on an individual policy basis rarely exceed statutory reserves.

8.49 Reserves provided on the basis of reasonably conservative assumptions as to interest and mortality may be less than expected nonforfeiture benefits so that a provision should be made for anticipated nonforfeiture benefits. In addition, withdrawals affect anticipated premiums and death benefits; therefore, the reserve computations should include appropriate provision for withdrawals, using anticipated withdrawal rates and contractual nonforfeiture benefits. An assumption for withdrawals is necessary even for term insurance policies which contain no withdrawal benefits, because of the effect of withdrawals on anticipated premiums and death benefits.

8.50 The present value of expected nonforfeiture benefits will usually be less than the aggregate cash values of all policies outstanding. Reserves determined in conformity with generally accepted accounting principles may be less than aggregate cash value, since, on a going concern basis, it is unrealistic to assume that all policies will be surrendered for cash.

8.51 Withdrawal rates used in computing reserves in conformity with generally accepted accounting principles should vary by plan, age, mode of premium payment, duration, and other factors. If composite rates are used, they should be representative of the company's actual mix of business.

8.52 As in the case of interest and mortality estimates, provision for the risk of adverse deviation from such estimates should be included.

8.53 *Policy Dividends.* Regulatory accounting practices for dividends on individual participating policies generally require a provision for dividends expected to be paid over the annual period subsequent to the date of the financial statements. Because of the impact of high initial policy acquisition costs, many companies issuing participating policies do not provide for or declare any dividends until two full annual premiums have been collected. For such companies there is no charge in the financial statements for a dividend provision in the first year that a participating policy is in force. Furthermore, undistributed earnings on participating business are included in unassigned surplus without regard to the fact that all such earnings may not inure to the benefit of the shareholders.

8.54 To determine the appropriate accounting in conformity with generally accepted accounting principles for participating business, it is necessary to consider any restrictions on the amount of earnings of participating policies which can inure to the benefit of shareholders. Such restrictions may be imposed by law, charter, or contract or they may be self-imposed as demonstrated by company policy or practice.

8.55 For those companies for which there are no earnings restrictions and who use dividend scales that may be unrelated to actual earnings, the specified policy dividends (based upon dividends anticipated or intended in determining gross premiums or as shown by published dividend projections at the date policies are issued) should be provided for ratably over the premium paying period. The specified dividend may be considered as a planned contractual benefit in computing reserves. However, it may be necessary to identify the amount of such dividends in order to calculate deferred income taxes in those cases where there is a question as to whether or not the dividend provision in the reserves, together with dividends declared or paid, may exceed the amount of dividends otherwise deductible for federal income tax purposes in the "with-and-without" calculations described in Appendix C.

8.56 For those companies for which there are limitations on the amount of earnings which may inure to stockholders, the policyholders' share of earnings on such business which cannot be expected to inure to stockholders, should be excluded from stockholders' equity by a charge to operations and a credit to an appropriate liability account in a manner similar to the accounting for earnings applicable to minority interests. Dividends declared or paid should be charged to the liability account. Dividends declared or paid on such business, in excess of the liability account, should be charged to operations.

8.57 In establishing provisions for policyholders' share of earnings, consideration must be given to whether earnings applicable to policyholders and to stockholders are determined based on earnings or whether they are determined on a basis unrelated to earnings. In those instances where earnings applicable to policyholders and stockholders are determined based on earnings before provision for policyholders' share, adjustments to conform to generally accepted accounting principles create timing differences between the inclusion of items in income and expense in adjusted financial statements and statutory statements. For the purpose of computing a provision for the policyholders' share of earnings, these timing differences should be considered in the same manner as timing differences between financial statements and tax returns are considered in calculating provisions for deferred income taxes. For example, a company, either by law or by intent, may determine that 90% of earnings on participating policies must inure to the benefit of participating policyholders. If earnings before dividends on its participating business, determined in conformity with generally accepted accounting principles, are $1 million, provision should be made for policyholders' share of earnings by a charge to operations for $900,000 (90% of $1 million). Actual dividends should be treated as previously described.

8.58 A second example relates to the legal restriction which limits the amount which may inure each year to stockholders from certain participating business to the greater of (1) 10% of the statutory earnings before policyholder dividends or (2) fifty-cents-per-thousand of participating life insurance in force.

8.59 For a company whose statutory earnings on participating business is subject to the 10% limitation and which is expected to continue to be in that situation, timing differences and their reversal will affect policyholders' and stockholders' share of participating earnings. For a company whose statutory earnings on participating business is subject to the fifty-cents-per-thousand limitation, and which is expected to continue to be in that situation, timing differences and their reversals will not affect the amount of earnings which can inure to stockholders. In the former case, a provision for policyholders' share of participating earnings should be made by a charge to operations based on 90% of reported predividend earnings. In the latter case, a provision should be made by a charge to operations for all reported predividend income in excess of fifty-cents-per-thousand.

8.60 Financial statements prepared in conformity with generally accepted accounting principles may reflect predividend income which would produce an apparent basis of calculation of policyholders' share of participating earnings that differs from the basis used in statutory statements. Such a change in basis of calculation should only be recognized if circumstances indicate that the timing differences which create the change in basis are likely to produce the same results for statutory purposes when such timing differences reverse.

8.61 A third example relates to stock companies which issue participating policies that are substantially similar to participating policies of mutual companies in that all, or substantially all, of the earnings on such policies inure to the benefit of policyholders. As in the other examples, earnings which cannot inure to stockholders should be excluded from stockholders' equity by a charge to operations and a credit to a liability account.

8.62 It should be noted that for participating business for which all, or substantially all, of the profits inure to policyholders or for which amounts that may inure to stockholders are limited to fifty-cents-per-thousand, adjustments to conform to generally accepted accounting principles will not affect net income or stockholders' equity. However, they will affect individual items within the financial statements. The auditor must determine whether the adjustments to individual items within the financial statements are necessary for a fair presentation of financial position and results of operations.

8.63 *Other Benefits.* Other guaranteed benefits, such as coupons, annual endowments and conversion privileges under term insurance contracts should also be provided for ratably, as opposed to being recognized only as such benefits become payable or mature.

Short Duration Term Life Insurance Contracts

8.64 Where gross premium revenues for short duration term life insurance contracts are recognized in proportion to the amounts of insurance in force, acquisition costs should be amortized in proportion to the amount of premium revenue recognized in each accounting period. Death and other benefits should be recognized in the period incurred, unless future premium revenues are not expected to be sufficient to cover such benefits and to recover unamortized acquisition costs. In such case, the resulting anticipated future losses should be recognized in the period when such losses become apparent. (See "Loss Recognition", paragraphs 8.89 through 8.93.)

8.65 Alternatively, companies may establish benefit reserves in accordance with generally accepted accounting principles and defer sufficient premium revenues so that the aggregate liability approximates the amount of premium revenues which would be deferred as a result of application of the method set forth under "Recognition of Premium Revenues—Term Contracts", paragraphs 8.18 and 8.19. In either case, acquisition costs should be deferred and amortized as described above.

Annuity Contracts

8.66 *Immediate Annuities.* A reserve for future annuity payments and expenses should be provided in an amount approximating the consideration less acquisition costs. Since all of the consideration is invested immediately at a known rate of interest when the reserve is set up and the flow of investment cash can be matched very closely to the flow of benefits, little provision for adverse deviation in investment results is necessary. Consequently, an interest rate based on the new money rate of the company in the year of issue may frequently be appropriate. The mortality assumption in annuity reserves involves the most significant risk of adverse deviation. It should be recognized that conservatism in providing reserves for annuity benefits means, in the case of the mortality assumption, a lower assumed death rate, since ordinarily the annuitant is paid an income throughout his lifetime and the effect of improved mortality is to diminish or, in some cases, eliminate annuity profits. Provision should be made for future expenses and deferred acquisition expenses should be amortized during the premium-paying period. Withdrawals under single premium immediate annuities are quite uncommon, the immediate benefit usually being limited to the present value of any guaranteed payments under the contract. As a result, withdrawals can generally be ignored in reserving for these plans.

8.67 *Deferred Annuities.* Deferred annuities, both the single premium and annual premium types, may be considered in two separate segments. The first segment is the accumulation or deferred period, during which there is relatively little risk to the company except failure to earn the guaranteed net interest rate. Net premiums are accumulated at interest, and much like a savings account, the cash surrender value may be withdrawn. The second segment is the payout or liquidation period, during which annuity income payments are made to the annuitant and the mortality risks described above are introduced.

8.68 For both types of deferred contracts, reserves should be based on the accumulation of a maturity value equal to the estimated initial reserve required at the time the annuity becomes income-paying. This maturity value will generally be larger than the initial reserve for current immediate annuities, particularly in the case of annual premium deferred annuities. This result follows from the difference in the timing of the cash flow and consequent investment. Under single premium deferred annuities, all of the net cash is invested immediately. However, some of the funds are usually reinvested and therefore, some recognition of the possibility of adverse deviations in the investment income is appropriate. For annual premium contracts, the factors affecting the choice of an investment income assumption are similar to those for life insurance. Accordingly, the considerations for the provision for adverse deviation are similar to those for life insurance.

8.69 *Individual Variable Annuities.* Under an individual deferred variable annuity contract, the contractholder's payments, after deduction of specified sales and administrative charges, are used to purchase units of a separate investment account. The units may be surrendered for their current value, although there is often a small surrender charge, or be applied to purchase annuity income. The contractholder bears the investment risk while the insurer guarantees mortality and maximum expense charges. Deferred contracts provide a death benefit during the deferred period under which the beneficiary usually receives the greater of the sum of premiums paid or the value of total units to the credit of the account at time of the contractholder's death.

8.70 Immediate variable annuity contracts are similar to matured deferred variable annuity contracts. The contractholder bears the investment risk and his income varies with the unit value adjusted for the investment return assumed in determining his initial income. The insurer guarantees mortality and maximum expense charge.

8.71 Individual variable annuity contracts provide two sources of income to offset expenses; namely, deductions from considerations or sales charges and asset charges or management fees. Except for acquisition costs, expenses are fairly level and should be matched with deductions from considerations. Sales charges will normally be used as the sole revenue base for matching acquisition costs. If they are insufficient to recover commissions and other acquisition costs, it may be appropriate to match certain acquisition costs against a portion of asset charges if there is sufficient margin in future asset charges. Any one-time fee charged at the time a contract is sold should be subtracted from related acquisition costs in determining the net amount to be amortized. These costs should be amortized over the period in which revenue is recognized.

8.72 Asset charges are intended to cover investment management, certain administrative expenses, mortality, and expense risks assumed by the insurer. Adjustments for matching purposes should not be required unless sales charges are insufficient to recover acquisition costs.

Accident and Health Contracts

8.73 *Long-Term Contracts.* Long-term individual and group accident and health contracts include noncancellable, collectively renewable, and guaranteed renewable contracts. Contracts which are renewable at the option of the company (cancellable contracts) may also be considered to be long-term when it can be demonstrated that such contracts are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts.

8.74 Costs (including acquisition expenses) should be allocated to premiums recognized over the current and expected renewal period. Accordingly, in addition to liabilities provided for incurred claims, reserves should be provided on the same principle as the reserves used for ordinary life insurance. Such reserves represent the present value of future costs less the present value of expected future valuation premiums, calculated using actuarial assumptions which, as for life insurance, make reasonable provision for the risks of adverse deviation. For guaranteed renewable, collectively renewable, and long-term cancellable contracts, estimates of future premiums should, in some cases, consider anticipated premium increases and their effect on lapses and anti-selection (the tendency for higher persistency of poor risks).

8.75 *Short-Term Contracts.* For accident and health contracts of a short duration, acquisition costs should be deferred and amortized in proportion to premiums recognized. Liabilities are required only for claims incurred, provided that there are no expected increases in the ratio of claims to premiums earned.

8.76 *Assumptions and Estimates.* Assumptions and estimates used in determining annual revenue and cost must properly reflect the unique characteristics of various types of accident and health coverage.

8.77 It is generally appropriate for companies to use the assumptions developed by the actuary. The auditor should expect the actuary to demonstrate the adequacy and appropriateness of the assumptions used in determining actuarial items.

8.78 In determining the reasonableness of the assumptions, the adequacy of the gross premium must be considered. The basic test of gross premium sufficiency is whether the benefit reserves plus the present value of expected future gross premiums is at least equal to the amount of unamortized acquisition costs plus the present value of future benefits and expenses. Any right to increase premiums and the right not to renew policies should be considered in this determination.

8.79 If a company has adequate and meaningful claim experience, it should use factors derived from such experience. Otherwise it would be appropriate to use recognized morbidity tables, adjusted for the effect of selection and variations in individual company underwriting practices.

8.80 Whereas the risk of adverse deviation with respect to interest may be most significant in a whole-life contract, the morbidity and lapse risks will likely be more significant in an accident and health contract. Anti-selection in renewal years or external trend factors, such as economic conditions and medical developments, may create higher rates of morbidity by policy duration than are provided in statutory tables or industry experience tables. The risk of anti-selection should be considered in the choice of morbidity assumptions.

8.81 *Morbidity.* Claim cost assumptions normally have a significant effect on the level of reserves. The claim cost assumptions used in the calculation of reserves should be based on realistic estimates of expected claim cost experience at the time premiums are established, or revised, or policies are issued. Consideration should be given to the level and incidence of claims for various types of coverage (e.g., noncancellable, guaranteed renewable, cancellable) and for such other factors as occupational class, waiting period, sex, age, and benefit period. Where company experience is unavailable or inadequate, an appropriate basis for claim cost assumptions would be industry experience adjusted for expected experience for a specific coverage.

8.82 *Lapse Rates (Withdrawals).* Lapse rates will have a material effect on the level of reserves. The guidelines mentioned previously should be considered in establishing lapse rate assumptions for individual and group accident and health insurance. Since lapse experience may vary sharply between types of contracts, the mix of business must be considered. It should be noted that for coverages which have increasing claim costs, it is not conservative to assume high lapse rates in renewal years.

8.83 *Interest.* As in the case of life insurance, where the effect of adjusting interest assumptions to a more appropriate rate would have a material effect on the financial statements, such an adjustment should be made. (See paragraphs 8.40 through 8.44, "Interest (Return on Funds Invested).")

Retrospective Commission or Experience Refund Arrangements

8.84 In those cases where retrospective commission or experience refund arrangements exist, care should be exercised to see that profits in any period do not include any amounts that are expected to be paid to the agent or other party in the form of experience refunds or additional commissions. A separate liability, based on experience, should be provided for such amounts.

Summary

8.85 In determining the provisions for risks of adverse deviation, it will be necessary to consider the individual assumptions; however, the provisions must be reasonable in relation to the total valuation premium.[2] Conservatism in determining such provisions should also be considered in relation to the effect of the provision on recognition of profit. Conservatism with respect to individual assumptions will not necessarily result in conservative recognition of profit. For example, a conservative provision for mortality could result in

[2]The valuation premium as used here represents that portion of the annual gross premiums required to provide for all benefits and expenses.

deferral of profit on ordinary whole-life contracts but could result in acceleration of profits on endowment contracts and on decreasing term contracts. In addition, because of the interrelationship of assumptions, conservatism with respect to one assumption may have the opposite effect on the results produced by other assumptions.

8.86 In determining the reasonableness of the assumptions, either individually or as composite factors, the adequacy of the gross premium must be considered. If the valuation premium exceeds the gross premium, a loss is indicated. Such loss should be recognized currently as discussed in the section "Loss Recognition."

8.87 In order to use a valuation premium less than the gross premium, the company must demonstrate the reasonableness of the assumptions used based on historical results, current operations, trends, and all other necessary factors to be considered in such judgments. Therefore, the valuation premium based on the assumptions to be used for a block of business should be tested in comparison to the gross premium.

8.88 A company should not arbitrarily use the gross premium as the valuation premium if its demonstrated experience and future outlook indicates that such practice is unduly conservative. For companies with narrow profit margins or companies with little experience, however, the use of the gross premium as the valuation premium may be most appropriate.

Loss Recognition

8.89 It is anticipated that the original assumptions will continue to be used ("locked-in") during the period in which reserves are accumulated so long as reserves are maintained at a level sufficient to provide for future benefits and expenses. This approach results in variances from original estimates being recognized in the accounting periods in which such variances occur.

8.90 It is possible that actual experience with respect to expenses, interest, mortality, morbidity, and withdrawals may be such as to indicate that accumulated reserves, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits and settlement and maintenance expenses related to the block of business and (b) to recover the unamortized portion of deferred acquisition expenses. The computation of such deficiency would take the following form:

Estimated gross premium reserve at valuation date:	
Present value of future payments for benefits and related settlement and maintenance expenses, computed using revised assumptions based on actual and anticipated experience	$ xx
Less present value of future gross premiums, computed using revised assumptions based on actual and anticipated experience	xx
Gross premium reserve	xx
Less reserve at valuation date, reduced by deferred acquisition expenses	xx
Reserve deficiency	$(xx)

8.91 This deficiency represents a loss which, in conformity with generally accepted accounting principles, should be recognized immediately by a charge to earnings to increase reserves and/or reduce deferred acquisition expense. Future annual reserve additions should be based on the revised assumptions. No charge should be made to record an indicated loss currently which will result in creating an apparent profit in the future. Gross premium reserves should be computed periodically for comparison with the actual reserves, and particularly when the company has experienced or anticipates adverse deviations from original assumptions that could materially affect the reserves.

8.92 While the computation can be made only by individual blocks of business, a provision for reserve deficiency may be required only if the aggregate reserves on an entire line of business are deficient. In some instances, the reserves on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits will be recognized in early years, and losses in later years. In such situations, appropriate adjustments should be made to reserves to eliminate the recognition of losses in later years.

8.93 Adjustments should always be made at a time losses first become apparent.

Deferred Income Taxes

8.94 Life insurance companies are not required to provide for deferred income taxes under regulatory accounting practices. Life insurance companies presenting financial statements in conformity with generally accepted accounting principles, however, must follow Accounting Principles Board Opinions No. 11, *Accounting for Income Taxes,** No. 23, *Accounting for Income Taxes—Special Areas,* and No. 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures).*

8.95 Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959. The Act contemplated taxation of total income, but the computation of tax is complex because of the manner in which total income is segmented between taxable investment income, taxable gain from operations, and taxable policyholders' surplus (gain from operations previously excluded from tax) and the inter-relationship of these elements. Further details concerning life insurance taxation and methods of computing deferred income taxes are discussed in Appendix C.

Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon **

8.96 Under regulatory accounting practices, investments in common stocks are carried at quoted market values, preferred stocks are generally carried at cost and bonds at amortized cost. Changes in the carrying values of common stocks representing unrealized appreciation or depreciation and realized gains or losses are charged or credited to unassigned surplus.

8.97 Except in the cases of securities brokers and dealers and investment companies, carrying bonds at amortized cost has been considered a generally accepted practice. Proper accounting for equity securities has been considered at length by the AICPA Insurance Accounting and Auditing Committee, by the Accounting Principles Board, and by other interested groups. However, no conclusions have been reached.

8.98 At the present time, most industrial and commercial companies account for investments in equity securities classified as current assets at the lower of cost or market. Gains and losses from the disposition of such assets

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* [Note: FASB Statement No. 109, *Accounting for Income Taxes,* is effective for fiscal years beginning after December 15, 1992. It supersedes APB Opinion Nos. 11 and 24, portions of APB Opinion No. 23, and FASB Statement No. 96, *Accounting for Income Taxes.*]

** FASB Statement No. 97 significantly impacts the recognition of premium revenues and loss recognition.

and losses from writing down investments to market have been included in the income statements of such companies. Insurance companies, securities brokers and dealers and investment companies generally use special methods of accounting for investments in equity securities. With the exception of preferred stocks owned by life insurance companies, these methods account for equity securities in the balance sheet at market value. Gains or losses on disposition of such investments and changes in market values have generally been accounted for by one of the following methods:

1. Some fire and casualty insurance companies follow the statutory form and include realized gains and losses on investments in determining net income in annual reports to stockholders and report unrealized gains or losses as direct increases or decreases in a special stockholder's equity account.
2. Some fire and casualty insurance companies present realized and unrealized gains and losses on equity securities and realized gains and losses on bonds in a separate statement.
3. Most life insurance companies follow the statutory form and include realized and unrealized gains and losses on all investments in unassigned surplus.
4. Securities brokers and dealers generally include realized and unrealized gains or losses on all investments in income as stated by the AICPA Committee on Stockbrokerage Accounting and Auditing in its audit and accounting guide, *Audits of Brokers and Dealers in Securities*.
5. Investment companies present realized and unrealized gains and losses on all investments in a separate statement.
6. Some insurance companies that are subsidiaries of noninsurance companies have restated investments in equity securities from market to cost for purposes of consolidation and recognize in income the realized gains and losses on sales of securities.

8.99 Because of the variety of alternative practices, life insurance companies may follow any of the foregoing, except alternative (4), until such time as generally accepted accounting principles for investments are more clearly defined by an authoritative opinion of the Accounting Principles Board or its successor. See Appendix H, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*.

8.100 Regardless of the method followed, realized and unrealized gains or losses, together with related income taxes, should be prominently displayed in the financial statements. Unrealized investment gains, net of related income tax, should be shown as a separate stockholders' equity account. When realized gains or losses are excluded from the income statement, the last item in that statement should be designated as "Income, excluding realized investment gains or losses."

Investments in Subsidiaries

8.101 Under regulatory accounting practices, life insurance companies are not permitted to consolidate subsidiaries. For regulatory reporting purposes, investments in subsidiaries are required to be valued using one of the following bases prescribed in the valuation manual published by the NAIC Subcommittee on Valuation of Securities:

1. The value of only such assets as would constitute lawful investments (admitted assets) for the insurer.
2. The net worth determined in conformity with generally accepted accounting principles if the financial statements of the subsidiary have been audited by an independent certified public accountant.
3. Book value as defined in the manual.
4. Cost adjusted for subsequent operating results determined in conformity with generally accepted accounting principles.
5. Market value of the common stock of the subsidiaries if such stock is listed on a national securities exchange.
6. Any other value which the company can substantiate to the satisfaction of the staff of the Subcommittee as being reasonable.

8.102 On whichever basis the investment is valued, the change in value each year is charged or credited directly to surplus as part of the capital gains and losses on investments. Accordingly, the income of subsidiaries is included in the parent's investment income only to the extent that dividends have been received.

8.103 For life insurance companies preparing financial statements in conformity with generally accepted accounting principles, investments in subsidiaries should be accounted for as purchases or poolings of interest in accordance with the provisions of APB Opinion No. 16, *Business Combinations,* and any cost in excess of net assets arising in purchase transactions should be accounted for in accordance with the provisions of APB Opinion No. 17, *Intangible Assets.*

8.104 For life insurance companies or life insurance holding companies whose subsidiaries consist of other life insurance companies and/or companies engaged in diverse financial activities, consolidated financial statements may be more meaningful than separate financial statements. However, consideration should be given to the presentation of separate financial statements of significant subsidiaries or operating groups. The presentation of financial statements for such companies reporting under the requirements of the Securities and Exchange Commission are set forth in Rules 3A-02 and 3-09 of Regulation S-X. Where more than one financial activity is involved, separate statements for each significant financial subsidiary or each significant group of financial subsidiaries will be required to be presented. See FASB Statement No. 94, *Consolidation of Majority-Owned Subsidiaries* for further guidance.

8.105 The publication of consolidated statements may require approval of insurance regulatory authorities. In some cases, consolidation may be permitted only if separate statements are also presented.

8.106 Investments in unconsolidated subsidiaries, corporate joint ventures and controlled companies should be carried on the equity method prescribed by Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.*

8.107 The financial statements of all consolidated and unconsolidated subsidiaries should, of course, be presented in conformity with generally accepted accounting principles.

Special Reinsurance Agreements

8.108 In addition to the usual reinsurance of excess risk described in paragraphs 3.27 through 3.32, some life insurance companies enter into special reinsurance agreements (usually of the coinsurance type) for the purpose of increasing their statutory surplus position to meet minimum capital and/or surplus requirements or to create enough taxable income to avoid the loss of an operating loss carryforward for tax purposes. To accomplish this, a company will seek another company with sufficient surplus or taxable income that is willing to assume a portion of the risk on a large block of business. Under regulatory accounting practices, such reinsurance agreements result in current income to the ceding company representing recovery of acquisition costs and an element of profit. The corresponding amount is treated as current expenses by the assuming company.

8.109 In order to account for such special reinsurance contracts in conformity with generally accepted accounting principles, it is necessary to determine whether the agreement is constructed so as to shift the economic risk. Many reinsurance agreements of the coinsurance type entered into for "surplus relief" may in essence be financing arrangements rather than reinsurance contracts. Agreements of the financing type often result in little, if any, shift in economic risk. Such agreements usually call for the ceding company to agree that the contract will not be cancelled until such time as the assuming company has recovered all monies advanced, and may provide that in the event of cancellation, the ceding company must refund the amount of "surplus relief" together with interest. These agreements frequently call for a large provisional commission and accomplish the desired payback through subsequent adjustments of the provisional commission based on experience.

8.110 In presenting financial statements in conformity with generally accepted accounting principles, net credits arising from financing, type reinsurance agreements should be treated as a deferred credit or liability by the ceding company. In the adjusted financial statements of the assuming company, net charges arising from these agreements should be treated as deferred charges or receivables.

8.111 Under generally accepted accounting principles for special reinsurance agreements which are constructed so as to shift a significant part of the economic risk from one company to another, that portion of the proceeds from the transaction which represents recovery of acquisition costs should be charged with the applicable unamortized acquisition costs. If the ceding company has agreed to do all the servicing of the business without adequate compensation, a liability should be provided for estimated future servicing costs under the agreement. Any gain or loss, if material, should be appropriately disclosed. The net cost to the assuming company should be treated as acquisition expense to be amortized over the premium-paying period on a basis consistent with that used for acquisition expense of other business.

Commitment Fees

8.112 Insurance companies sometimes obtain commitment fees in connection with the placement of mortgage loans and recognize such fees as income in the period the commitment is made. In presenting financial statements, in accordance with generally accepted accounting principles, commitment fees which exceed normal charges for such commitments are considered as adjustments of the effective interest rates of permanent financing. After reduction of direct costs and related expenses, normal fees (those fees currently being charged for commitments within the industry) should be recognized as income over the commitment period and excess fees should be recognized as an adjustment to the effective interest rate over the period of the mortgage loans. However, in instances where the mortgage loan is not ultimately taken down, the unamortized commitment fee should be recognized as income at the time the company's obligation ceases.

Stockholders' Equity

8.113 Stockholders' equity accounts are discussed in chapter 7, "Capital and Surplus." The equity accounts for a stock life insurance company are similar to those of other corporate enterprises.

8.114 In order to present life insurance company equity accounts in conformity with generally accepted accounting principles, it will be necessary to reclassify the regulatory accounts to show, as applicable, (1) capital stock (including disclosure of all pertinent data); (2) capital in excess of par value; (3) retained earnings, showing restricted and unrestricted amounts separately; and (4) unrealized investment gains or losses. Disclosure requirements related to statutory surplus and restrictions on retained earnings or stockholders' equity, as appropriate, are described in chapter 7, "Capital and Surplus" and in chapter 10, within the section titled "Disclosure Requirements."

Mandatory Securities Valuation Reserve (MSVR)

8.115 In most states, life insurance companies are required to establish, as a liability, a mandatory securities valuation reserve in accordance with a formula adopted by the National Association of Insurance Commissioners' (NAIC) Committee on Valuation of Securities. The reserve is established by a charge to unassigned surplus, and annual changes in the reserve balance are also charged or credited annually to unassigned surplus.

8.116 Under generally accepted accounting principles, valuation reserves for losses anticipated on assets such as receivables, inventories, and investments should be deducted from the assets to which they relate. There is a further requirement that such valuation allowances be provided by charges to earnings and that when losses are realized, they will be charged to the reserves created for that purpose. The Mandatory Securities Valuation Reserve is not a valuation reserve, but is an appropriation of surplus which should be included in the equity section of the balance sheet.

Nonadmitted Assets

8.117 Certain assets designated as "nonadmitted assets" (principally furniture and equipment, agents' debit balances, and certain other classes of receivables) are eliminated from the statutory balance sheet by a charge to surplus. The treatment of furniture and fixtures varies in that they may be capitalized and depreciated by annual charges to income with the undepreciated balances charged against surplus for regulatory accounting purposes. Alternatively, furniture and fixtures may be charged to expense upon purchase. In presenting financial statements in conformity with generally accepted accounting principles, nonadmitted assets should be restored to the balance sheet where appropriate. Receivables, however, must be subjected to the usual review as to collectibility, and appropriate valuation reserves should be established by a charge to income.

Chapter 9

Auditing Procedures

9.01 Auditing procedures applicable to accounts maintained in conformity with regulatory accounting practices are set forth in Part I following the description of each account described therein. The adoption of generally accepted accounting principles for financial reporting of life insurance companies requires additional auditing procedures, the most significant of which relate to reserves and acquisition expenses. These additional auditing procedures with respect to reserves and other accounts are set forth below. The discussion under reserves deals with acquisition expenses where such expenses are included as part of the reserving method. When acquisition costs are deferred and amortized separately, additional procedures will be required with respect to amortization of such costs. Such procedures would include those required to determine the appropriateness of the method followed and the accuracy of its application. They would not be significantly different from auditing procedures with respect to amortization of other deferred charges so as to require additional comment herein.

Reserves

General

9.02 To determine whether adjusted reserves calculated in conformity with generally accepted accounting principles are fairly presented, the following basic audit procedures should be followed:

1. The inventory of policies in force should be reviewed and tested for completeness and accuracy.
2. The reasonableness of assumptions and propriety of the actuarial factors used in reserve calculations should be reviewed and tested.
3. The application of the actuarial factors to the inventory should be tested.

9.03 The principal change in auditing reserves calculated in conformity with generally accepted accounting principles as compared with auditing statutory reserves relates to the determination of the reasonableness of assumptions and the propriety of the actuarial factors.

9.04 If a complete inventory of policies in force is used in the reserve computation, the tests of such inventory for completeness and accuracy will be the same as those performed in the audit of the statutory reserves. If a model of the inventory is used to determine the adjusted reserves, the auditor should be satisfied as to the propriety of the model.

9.05 When using models, the derivative reserve factors for key plans are extended to other plans that can be properly placed in the same category. An appropriate model would include those plan and age groupings and durations required to make the model appropriately sensitive to material changes in the plan and age distribution. The auditor must at least be satisfied that the model effectively reproduces the statutory results as to insurance in force, gross premiums, expenses and reserves. In most cases, he will want to see the model tested under varying conditions to determine whether it is properly responsive.

9.06 Unlike statutory reserves for which the factors for many plans are published, a company calculating reserves in conformity with generally accepted accounting principles should develop its own factors based on assumptions that are reasonably conservative and that include provision for the risk of adverse deviation from such assumptions. The auditor must be satisfied as to the following:

1. The reasonableness and appropriateness of the basic underlying assumptions entering into the calculations of the reserve factors, including the reasonableness of the provision in the factors for the risk of adverse deviation.
2. The appropriateness of the actuarial formulas.
3. The accuracy of the factors resulting from the application of the formulas to the assumptions.

9.07 Assumptions can be classified in terms of their applicability to the established company and to the new company. Each assumption must be determined individually even though such assumptions may be applied in the aggregate in the computation of adjusted reserve factors. Documentation of the individual assumptions will facilitate the measurement of variances from each of the assumptions in future years to determine whether reserve differences exist. Such measurement will probably be made by comparing revised valuation premiums with actual gross premiums. Should the revised valuation premiums exceed the actual gross premiums by a material amount, a loss should be recognized as described earlier in the chapter.

Utilization of Actuaries

9.08 The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified as an actuary. Although the independent auditor may be informed in a general manner about matters of an actuarial nature, he does not purport to act in the capacity of an actuary. Therefore, auditors will need the advice of a qualified actuary [3] in such matters.

9.09 The work done by the auditor necessitates close coordination and cooperation with consulting actuaries, company actuaries, or, possibly, insurance department actuaries. The auditor should utilize the expertise of an actuary in much the same manner as he uses the expertise of attorneys or those in other areas of specialization in forming a judgment in his own area of expertise, namely, expressing his opinion on the fairness with which overall financial position and results of operation are presented. The auditor is responsible for obtaining sufficient competent evidential matter as a basis for forming his opinion. The education and professional experience of the independent auditor and/or his staff will dictate the extent to which he must utilize the services of a qualified actuary in obtaining competent evidential matter and in forming an opinion. An auditor who is sufficiently experienced in auditing life insurance reserves may be able to form an opinion by working with the qualified actuary who was responsible for calculating the reserves, or with insurance department actuaries when they verify the reserves. In other cases, the auditor may need to utilize the services of a qualified consulting actuary to assist him in auditing life insurance reserves.

9.10 Normally, a company will not compute required reserves for individual life, noncancellable and guaranteed renewable accident and health policies or other benefits that require actuarial reserves on each individual policy, but will summarize insurance in force at statement date by policy plan, year of

[3] Currently, not all jurisdictions specify qualifications for actuaries. Membership in the American Academy of Actuaries, a comprehensive organization of the profession in the United States, is generally considered to be acceptable evidence of professional qualifications.

issue, and age at issue. The actuary works with these summaries in determining that appropriate reserve factors have been used according to the terms of the insurance policies and the actuarial assumptions made. He also determines the effect of changes in basis of reserve factors applied where the effects of such changes are reported as charges or credits to surplus in the annual statement filed with regulatory bodies. As it relates to statutory reporting, his responsibility is to see that such reserves are adequate and in accordance with statutory requirements.

9.11 Reserve assumptions used in computing reserves in conformity with generally accepted accounting principles will require the actuary to look at the reserving method from a different perspective. His judgment will extend to the reasonableness of the reserves, determined on a basis which is in conformity with generally accepted accounting principles, and the consistent application of factors used in calculating the reserves. Although an actuary has been involved in these determinations, perhaps even to the extent of testing clerical accuracy, it is incumbent upon the auditor to be satisfied that reserves are fairly stated on a consistent basis. To the extent that independent actuaries (i.e., outside experts) are utilized in the process of reviewing amounts established for reserves, the auditor should plan his work with the consulting actuary to insure a coordinated program to achieve the objectives of the audit. Such coordinated review should enable the auditor to restrict the extent of his testing of reserve factors, in-force records and clerical accuracy of listings from that which would otherwise be required absent the utilization of the consulting actuary.

9.12 Actuaries are not practicing auditors; they are not specifically trained in auditing procedures, nor are they governed by generally accepted auditing standards. Therefore, there is no justification for the auditor to omit all audit procedures or to perform only token procedures as to the reserves reviewed by the consulting actuary unless the terms of the engagement contemplate a qualification or denial of opinion by the auditor.

9.13 The foregoing guidelines for using the assistance of qualified actuaries should also be applied to premiums deferred and uncollected, policyholders' dividends and other actuarially determined amounts, the auditing procedures for which are described elsewhere in this guide.

9.14 The auditor should obtain a written opinion from the qualified actuary who calculated the reserves or who verified the reserves, the same as he would obtain letters from counsel on legal matters and other representations from management on various matters.

9.15 If the auditor has any substantial doubt as to any assertion of material significance (such as the life reserves and the changes therein), he must refrain from expressing an opinion until he has obtained sufficient evidential matter to remove such substantive doubt, or he must express a qualified opinion or disclaimer of opinion.

Audit Guidelines for an Established Company

9.16 In his review of the reasonableness and appropriateness of the assumptions entering into the calculations of the reserve factors, the auditor will find the following guidelines helpful. However, he must remember that the factors will include provisions for the risk of adverse deviations that must be taken into account in determining the reasonableness of the factors.

9.17 *Interest.* For current issues, the company's current and historical portfolio yield, trends in such yield, new money rates, and cash flow projections for the particular mix of the investment portfolio should be considered in estimating expected yields. Some companies may use a level interest assumption, while other companies may employ scaled down or graded interest assumptions since it is difficult to estimate yields so far into the future. Any anticipated effect of economic conditions on the interest assumption should be similarly considered for expense assumptions.

9.18 For policies issued in previous years, gross premiums or asset share studies, if available, should be reviewed as a part of the test of the reasonableness of interest rates and yields experienced at the time the policies were issued.

9.19 In testing the interest assumption, the adequacy of the gross premium should be considered, as discussed previously. As a test of the interest assumption, the auditor might consider the average new money rate (the net investment yield attributable to new investments made each year) or the average portfolio yield rate for some reasonable period of time, such as 20 years.

9.20 For companies not having sufficient experience, the auditor could substitute the average rate on long-term U.S. Government bonds, or some similar high-quality investment, for its new money rate and the industry yield for the portfolio rate for each year for which the company did not have any experience during the period being considered.

9.21 While it is not possible to establish a precise limitation or a guideline that will apply in all circumstances, the auditor should be satisfied that the rate used is reasonable and conservative. The auditor has an additional burden when the rate used varies significantly from historic rates measured as described above. The auditor should consider the facts and circumstances and make a professional judgment as to the reasonableness and conservatism of the rate used.

9.22 *Expenses.* Unit costs per policy or per thousand should be developed, based on cost studies. Such studies should segregate acquisition costs from costs that are attributable to the maintenance of policies. The audit of such cost studies should be the same as would be conducted in auditing any cost system.

9.23 As discussed earlier in this chapter, these cost studies should also isolate development and other similar expenses so that a determination can be made as to whether any of such costs should properly be deferred. The deferral of development or similar expenses requires judgment on the part of both the company and the auditor with an overriding consideration as to future benefit, consistency, amortization period, and the probability of recovery. (See paragraphs 8.89 through 8.93, "Loss Recognition.")

9.24 If data necessary to develop unit costs based on cost studies are not available for policies issued in previous years, it will be necessary to estimate acquisition costs. Data used in the gross premium determination or asset share studies at the time policies were issued could be used. In addition, data related to commissions may be available so that estimates will be limited to other acquisition costs. Renewal expense assumptions should recognize the possibility of inflation.

9.25 *Mortality.* The auditor should ascertain that the company properly considers its underwriting practices in its selection of assumed mortality rates.

9.26 For current issues, the company should use its own experience, if such experience is credible or, if appropriate, data from recently published tables.

9.27 For policies issued in previous years, the company's experience or published experience used in the gross premium calculations should be used, provided that subsequent gross premium calculations do not result in reserve deficiencies requiring adjustment.

9.28 *Withdrawals.* To determine the reasonableness of withdrawal assumptions used, the auditor should review historical lapse rates and recent data or studies of the company's termination rate experience. The auditor should also ascertain whether there have been significant changes in underwriting practices which might affect the validity of historical data.

9.29 Companies should use published withdrawal tables such as Linton or Moorhead only if the results produced by the use of such tables are comparable with the company's actual withdrawal experience.

9.30 Different types of business such as short-term endowment, life policies and long-term endowment, level-term, and other term contracts have different termination characteristics. In addition, non-annual mode business often experiences higher termination rates than annual mode business. Therefore, consideration should be given to the mix of business and the mode of premium payments in determining the reasonableness of withdrawal assumptions. In all cases, the auditor should request adequate documentation to support conclusions on the part of a company. The auditor should also determine that the company's actual cash value scale is used in the reserve calculation.

9.31 *Policy Dividends.* The auditor should make tests to determine that the dividends provided are in accordance with such regulation, charter, contract, or published or intended dividend scales as are appropriate. He must be satisfied that net income and retained earnings are not being increased by participating policy earnings which will not be likely to become available or can never become available to shareholders. In the case of companies with no restrictions as to participating policy earnings, it will be necessary to determine that an appropriate provision is made for dividends where current dividends or expected future dividends vary significantly from the dividend scale anticipated when the policies were issued. (See paragraphs 8.89 through 8.93, "Loss Recognition.")

Audit Guidelines for a New Company

9.32 Because of the lack of reliable experience for a new company, the auditor will have difficulty in forming an opinion as to the reasonableness of assumptions to be used in calculating adjusted reserves and as to the related recoverability of acquisition costs to be deferred. In some instances, the auditor may use industry data or data for companies similar to that being audited as a test of the reasonableness of the assumptions and recoverability of costs. Such data should be used only as a test and should not be used as a substitute for professional judgment. In exercising his judgment about new companies, the auditor will probably need to be more conservative than he would be with an established company. If he cannot be satisfied as to the adequacy of reserves and recoverability of acquisition costs, he may feel compelled to qualify his opinion or to disclaim an opinion.

9.33 The auditor may be satisfied if the company uses very conservative provisions for adverse deviations, principally for interest and mortality, so as to make the valuation premium approximate the gross premium until the company has demonstrated consistent experience for a reasonable period of time. In such instances, the auditor will still need to review projections and be satisfied that the implicit factors for interest, expenses, mortality, withdrawals, dividends, and other benefits resulting from the use of gross premium as the valuation premium, are capable of being attained by the company.

9.34 In order for a new company to depart from regulatory practices or to use a valuation premium which is less than the gross premium, the auditor should consider each of the assumptions as described below. In considering these assumptions, the assistance of a qualified actuary should be utilized.

9.35 *Expenses.* As for all companies, only those acquisition expenses which are recoverable should be deferred and amortized. In a new company, additional conservatism may be required in testing recoverability of expenses to be deferred. For example, it may only be appropriate to defer the most directly variable expenses such as commissions and medical examination fees. In any event, the auditor should be satisfied that the company can retain a sufficient volume of business to recover such costs.

9.36 *Interest.* For companies having little or no investment experience, the auditor may find it helpful to compare the interest rate used by the company with benchmarks such as the current average industry yield rate or average rate on long-term U.S. Government bonds or similar high-quality investment for some reasonable period of time. In some instances, the auditor may be satisfied if the company uses the maximum rate permitted by the state in which the company is domiciled.

9.37 *Mortality.* The auditor may be satisfied with the use of an accepted published table if it is representative of the company's experience and underwriting practices. In some cases, the auditor may only be satisfied with the use of commissioner's tables or other more conservative tables.

9.38 *Withdrawals.* For a company with little experience, the auditor should review industry data or data for companies similar to the one being audited. He may be satisfied with the use of published tables if such tables are conservative and produce results which are not more favorable than industry experience or the company's experience to date.

Other Accounts

General

9.39 Auditing procedures with respect to investments, other than investments in subsidiaries, and mandatory securities valuation reserves do not require any auditing procedures in addition to those described in Part I. Additional auditing procedures with respect to other accounts described in this section are set forth below.

Deferred Income Taxes *

9.40 The initial procedure for auditing deferred income taxes for life insurance companies is to determine the existence and the amount of timing differences which enter into the determination of deferred income taxes. This procedure is complicated by the fact that the Life Insurance Company Income Tax Return does not include a reconciliation of income per books with income per tax return. Accordingly, auditors must reconcile income per the annual statement filed with the state and with any additional differences between the annual statement and financial statements presented in conformity with generally accepted accounting principles with income tax per the tax return.

* [Note: FASB Statement No. 109, *Accounting for Income Taxes,* is effective for fiscal years beginning after December 15, 1992. It supersedes APB Opinion 11, *Accounting for Income Taxes,* and FASB Statement No. 96, *Accounting for Income Taxes.*]

9.41 When all timing differences have been identified, their proper inclusion in a with-and-without calculation must be verified, following the computational techniques described in Appendix C. All facts and circumstances should be reviewed and evaluated in those cases where it has been determined by the company that timing differences will not produce tax effects when they reverse.

Investments in Subsidiaries

9.42 The financial statements of consolidated subsidiaries should be subjected to the same auditing procedures as applied in other industries. Where material, such financial statements may require auditing procedures to the same extent as the parent company.

9.43 Auditing procedures with respect to corporate joint ventures and controlled companies are described in SAS No. 1, section 332, *Long-Term Investments.*

Special Reinsurance Agreements

9.44 All reinsurance agreements should be examined as indicated in Part I. However, for companies reporting in conformity with generally accepted accounting principles, additional procedures are required to determine whether any of these reinsurance agreements are of the type requiring special accounting treatment described under "Special Reinsurance Agreements," paragraphs 8.108 through 8.111.

Commitment Fees

9.45 Additional auditing procedures are required with respect to commitment fees to determine whether normal fees are being recognized as income over the commitment period, and whether any such fees exceed normal fees (those fees currently being charged for commitments within the industry) which should be recognized as an adjustment to the effective interest rate over the period of the mortgage loan.

Stockholders' Equity

9.46 Stockholders' equity accounts must be audited to determine the proper classification of such accounts in conformity with generally accepted accounting principles. Such accounts should also be audited to determine whether they include transactions which should be reflected in net income to conform to generally accepted accounting principles and as to whether stock dividends have been properly accounted for.

Nonadmitted Assets

9.47 Nonadmitted receivables which are restored to the balance sheet must be subjected to the usual auditing procedures necessary to determine their existence and collectibility.

9.48 Furniture and fixtures should be subjected to the usual auditing procedures for additions and disposals and depreciation thereon.

Chapter 10

Disclosure Requirements

10.01 SAS No. 32, *Adequacy of Disclosure in Financial Statements,* states that "The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters." APB Opinion No. 22, *Disclosure of Accounting Policies,* also states that ". . . a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements." This chapter deals only with those disclosures peculiar to life insurance company financial statements presented in conformity with generally accepted accounting principles. A description of matters requiring disclosure and the illustrative notes are presented below.

Recognition of Premium Revenue and Related Expenses

10.02 Disclosure of principles relating to the recognition of premium revenues and related expenses might be worded as follows:

> Premiums are reported as earned when due or, for short duration contracts, over the contract period. Benefits and expenses are associated with earned premiums so as to result in recognition of profits over the life of the contracts. This association is accomplished by means of the provision for liabilities for future benefits and the amortization of acquisition costs.

Deferred Acquisition Costs

10.03 Unamortized acquisition costs should be presented in the balance sheet as a deferred charge. The nature of the costs deferred, the method of amortizing such costs, and the amount of amortization charged to income for the period should be disclosed in a note to the financial statements. An example of such a note for a company issuing principally life insurance contracts is set forth below.

> The costs (principally commissions) of acquiring new business, certain expenses of the policy issuance and underwriting department (such as medical examination and inspection report fees) and certain variable agency (field office) expenses all of which vary with, and are primarily related to, the production of new business have been deferred. These deferred acquisition costs are being amortized over the premium-paying period of the related policies in proportion to the ratio of the annual premium revenue to the total premium revenue anticipated. Such anticipated premium revenue was estimated using the same assumptions as were used for computing liabilities for future policy benefits. Amortization charged to income for the years ended December 31, 197X and 197X amounted to $ xxxxx and $ xxxxxx, respectively.

10.04 The note should be appropriately modified for those companies that issue a material amount of contracts other than life contracts.

Policy Liabilities

10.05 The methods employed and the assumptions used in calculating policy reserves should be disclosed in the financial statements along the following lines.

10.06 Liabilities for future policy benefits have been computed by the net level premium method based upon estimated future investment yield, mortality and withdrawals. The composition of the policy liabilities and the more material assumptions pertinent thereto are presented below:

Ordinary Life Insurance in Force	Amount of Policy Liability	Years of Issue	Bases of Assumptions		
			Interest Rates	Mortality	Withdrawals
$	$	19___	X% or X% to Y%	Tables or Company's Experience	Tables or Company's Experience
$	$				

Similar information should be disclosed for annuities, accident and health insurance, or other material lines of business.

Participating Policies

10.07 The relative amount of participating business in force, the method of accounting for dividends and the amount thereof should be disclosed in a note similar to the following.

> Participating business approximates X% of the Company's ordinary life insurance in force.
>
> The amount of dividends to be paid is determined annually by the Board of Directors. Amounts allocable to participating policyholders are based on (legal requirements), (Company charter or other contractual obligation), (Company practice), or (published dividend projections or expected dividend scales).

10.08 Where amounts allocable to participating policyholders are based on earnings on such policies, the following additional disclosure is required.

> $ xxx was allocated to participating policyholders representing approximately Y% of total earnings on participating policies for the year.

Stockholders' Equity*

10.09 The auditor must be cognizant of statutory requirements for surplus and/or capital. The ability to meet statutory requirements and to avoid statutory impairment or insolvency is critical in connection with the fair presentation of the financial statements.

10.10 The significance (possible impairment and effect on ability to pay dividends to stockholders), as well as the amount of statutory surplus should be disclosed. Although stockholders' equity presented in conformity with generally accepted accounting principles may substantially exceed statutory capital and surplus, the amount which is restricted by statutory requirements should be disclosed. Examples of the application of this disclosure requirement follow.

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* See FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (in Appendix H), for additional guidance on required disclosures relating to stockholders equity.

Example 1

A company issuing nonparticipating policies is domiciled in a state which permits the payment of dividends out of total capital and surplus provided that minimum capital and surplus of $250,000 each is maintained. Its balance sheet shows the following:

Capital stock		$ 750,000
Capital in excess of par value		500,000
Net unrealized investment gains (losses)		250,000
Retained earnings:		
Statutory unassigned surplus	$350,000	
Retained earnings in excess of statutory unassigned surplus	400,000	750,000
Total stockholders' equity		$2,250,000

10.11 Under these circumstances, there is no legal limit on the amount of retained earnings available for distribution to stockholders. Since the amount of statutory surplus can be determined from the information disclosed in the body of the financial statements, no further disclosure is required if there is no evidence of imminent impairment.

Example 2

Capital stock		$ 200,000
Capital in excess of par value		500,000
Net unrealized investment gains (losses)		50,000
Retained earnings:		
Statutory unassigned surplus (deficit)	($200,000)	
Retained earnings in excess of statutory unassigned surplus (deficit)	300,000	100,000
Total stockholders' equity (Note X)		$ 850,000

Assuming the same minimum capital and surplus requirement of $250,000 each as in Example 1, a restriction would exist in the above situation. The minimum statutory capital and surplus requirement amounts to $500,000, and since capital, surplus and unassigned surplus on a statutory basis is only $550,000, only $50,000 of total stockholders' equity (the amount by which capital and surplus determined in accordance with regulatory practices exceeds minimum capital and surplus) shown above is unrestricted. This fact should be disclosed along the following lines:

> Under applicable laws and regulations, the Company is required to maintain minimum capital and surplus, determined in accordance with regulatory accounting practices in the aggregate amount of $500,000. Accordingly, only $50,000 of the total stockholders' equity is unrestricted.

If, in addition to requiring minimum capital and surplus of $250,000 each, state law prohibits the payment of dividends from any source other than statutory unassigned surplus, total stockholders' equity would be restricted in Example 2 above. In this situation, the disclosure required would be changed to read as follows:

> Under applicable laws and regulations, the Company is required to maintain minimum capital and surplus, determined in accordance with regulatory accounting practices, in the aggregate amount of $500,000 and may not pay dividends to stockholders in the absence of statutory unassigned

surplus. Total stockholders' equity exceeds the minimum capital and surplus required by law by $50,000. However, until the statutory unassigned deficit ($200,000) is eliminated, no dividends may be paid to shareholders.

10.12 A similar restriction in Example 1 would restrict the amount of stockholders' equity available for dividends to $350,000 and disclosure similar to the above would be required.

10.13 In the foregoing examples, it was assumed that no participating business was involved. In the case of companies issuing participating policies, stockholders' equity determined in conformity with generally accepted accounting principles should exclude any undistributed participating earnings. However, the amount of statutory unassigned surplus could include such amounts, since there is generally no statutory requirement to establish a liability for undistributed participating earnings. The amount of undistributed participating earnings included in statutory unassigned surplus should be considered in determining the amount of retained earnings or total stockholders' equity not available to stockholders.

10.14 In addition to the requirements for disclosure, as in the case of any other business, the auditor must be satisfied that the values at which the assets are shown can be realized in the ordinary course of business. There may be situations, as in Example 2 above, in which a company's ability to continue to do business may be deteriorating toward the point of statutory capital impairment or insolvency. In addition, realization of asset values in the ordinary course of business may be dependent upon such future events as profitable operations or the injection of new capital.

10.15 In some instances, a company's financial statements prepared in conformity with generally accepted accounting principles may show stockholders' equity when its statutory surplus is below the minimum required by law (or where surplus impairment is likely or imminent). While there may be evidence that such condition is only temporary, the auditor must determine what action, if any, is intended by regulatory authorities. Disclosure of the relevant facts should be made in the financial statements. There may be circumstances where the possible effect of the uncertainties is such that the auditor would need to consider qualification of his opinion or possible disclaimer of opinion on the financial statements taken as a whole.

10.16 When financial statements are presented on the basis of generally accepted accounting principles, it would be desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a reconciliation of net income and stockholders' equity determined under generally accepted accounting principles with net gain from operations and capital and surplus determined under regulatory accounting practices. The reconciliation, in the form of either a note or supplemental financial statements, would include descriptions of differences in the two methods. Examples of such reconciliations are shown in Appendix A. In addition, it would be desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a condensed statutory balance sheet in a note to the financial statements.

Federal Income Taxes

10.17 Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959 (See Appendix C). Because of the peculiarities of this Act, certain matters of disclosure relative to accounting for income taxes should be considered. These include, but are not necessarily limited to, the following:

1. The basis upon which current and deferred income taxes have been provided.
2. Disclosures relating to "Policyholders' Surplus" as defined in the Internal Revenue Code and as prescribed by Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes—Special Areas.*
3. That portion of retained earnings in excess of statutory unassigned surplus upon which no current or deferred federal income tax provisions have been made and the reasons therefor.
4. Unused operating loss carry-forwards (described as operations loss deductions in the Code) including amounts and dates of expiration.

Reinsurance

10.18 Material reinsurance transactions and their effects on the financial statements should be disclosed. (See FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*)

PART III

Auditors' Reports

Chapter 11

*Auditors' Reports**

Types of Reports

11.01 *Financial Statements in Conformity With Generally Accepted Accounting Principles.* The insurance laws of some states contain varying degrees of prohibitions against the publication by insurance companies of financial statements based on accounting practices differing from those used in the preparation of the annual statement filed with the state. In many cases regulatory authorities require that financial statements be prepared on the same basis as used in the annual statement filed.

11.02 The independent auditor should follow the requirement of paragraph 38, chapter 10 of Statement on Auditing Procedure (SAP) No. 33 which includes the following statement which is applicable when financial statements of life insurance companies are presented in conformity with regulatory practices:

> . . . material variances from generally accepted accounting principles, and their effect should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or adverse opinion on such statements. However, an adverse opinion may be accompanied by a piecemeal opinion on the unaffected items in the statements or on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used in these instances are illustrated below. Examples of supplementary data which might be used to reconcile income and surplus on a regulatory basis to net income and stockholders' equity as determined in accordance with generally accepted accounting principles are given in Appendix A. The suggested language and format should, of course, be adapted to the particular circumstances.

11.03 Where acceptable to the state regulatory authority, the preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles. In such cases, the independent auditor should follow the standard short-form report described in SAP No. 50. If financial statements are presented on this basis, it is desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a reconciliation of net income and stockholders' equity determined under generally accepted accounting principles with net gain from operations and capital and surplus determined under regulatory accounting practices.

11.04 *Effects of Variances From Generally Accepted Accounting Principles Disclosed in the Financial Statements, Notes, or Supplementary Data. Qualified opinion*—when the financial statements of a life insurance company are prepared in conformity with regulatory practices, with disclosure of the effects of the variances from generally accepted accounting principles which are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

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* This chapter was originally drafted on the basis of concepts described in Statement on Auditing Procedure (SAP) No. 33. That statement has been superseded by SAS No. 58, *Reports on Audited Financial Statements.* Changes to conform this chapter to SAS No. 58 will be made in future editions.

We have examined the balance sheet of X Life Insurance Company at December 31, 19__, and the related statements of operations and changes in surplus and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ________. The effects on the accompanying financial statements of the variances between such practices and generally accepted accounting principles are described in Note 1.[4]

In our opinion, except for the effects of the matters referred to in the preceding paragraph, the accompanying financial statements present fairly the financial position of X Life Insurance Company at December 31, 19__, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

11.05 If a statement of changes in financial position on a statutory basis is not presented, such an omission should be dealt with in accordance with SAP No. 50.

11.06 *Adverse opinion*—when the financial statements of a life insurance company are prepared in conformity with regulatory practices, and when the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. Such an adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. Under these circumstances, the independent auditor's report would include a scope paragraph, expanded to include references to supplementary data when such data are presented separately as opposed to being included in notes to the financial statements, and a second paragraph referring to the variances from generally accepted accounting principles which would be worded as in the example under "qualified opinions" above. The opinion paragraph might be worded as follows:

It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the accompanying financial statements do not present fairly the financial position of X Life Insurance Company at December 31, 19__, or the results of its operations or changes in its financial position for the year then ended, in conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' equity and net income present fairly stockholders' equity at December 31, 19__, and the net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[5]

11.07 When the supplementary data are included in a note to the financial statements rather than in supplementary statements, the last sentence of the opinion would read as follows:

It is our opinion, however, that the supplementary data included in Note __ present fairly the stockholders' equity at December 31, 19__, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis conistent with that of the preceding year.

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[4] If the effects of the variances are not described in a note, they should be set forth in this paragraph. The suggested wording for such a note is included in Appendix A.

[5] A suggested format for such statements of adjustments is illustrated in Appendix A.

11.08 *Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined.* When the financial statements of a life insurance company are prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined, the auditor should ordinarily disclaim an opinion. In such instances his opinion might read as follows:

(Standard scope paragraph as in paragraph 11.04)

> The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the Insurance Department of the State of ________ The variances between such practices and generally accepted accounting principles are described in Note X.[6] The effects on the accompanying financial statements of the differences between such practices and generally accepted accounting principles have not been determined. Therefore, we do not express any opinion on the accompanying financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

11.09 Even though the effects of the differences between regulatory practices and generally accepted accounting principles have not been determined, the auditor may be able to satisfy himself that such effects (a) would be immaterial so as to permit an unqualified opinion, (b) would be sufficiently material to require a qualified opinion, or (c) would be so material as to require an adverse opinion.

11.10 *Reports on Presentations in Conformity With Regulatory Practices.* SAP No. 33 states the following:

> In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

11.11 When the auditor is asked to report in this manner, he may accomplish this in any of the foregoing circumstances by adding the following to the opinion paragraph:

> Also in our opinion, (It is our opinion, however, that) the accompanying financial statements present fairly the financial position of X Life Insurance Company at December 31, 19__, and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ________, applied on a basis consistent with that of the preceding year.

11.12 *Variances Not Affecting All Financial Statements.* In those instances where the effects of variances from generally accepted accounting principles have been determined and are material to one or more but not all of the financial statements, the auditor's report need take exception to only the statements so affected and may include an unqualified opinion on the statements not so affected.

11.13 *Comparability of Financial Statements.* A change in financial reporting from a regulatory basis to the basis of generally accepted accounting principles is a change involving the generally accepted auditing standard of reporting as to consistency as described in SAP No. 53. Such a change requires disclosure in the opinion paragraph of the auditor's report. Ordinarily, the

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[6] If the variances are not described in a note to the financial statements, they should be set forth in the auditor's report.

auditor should express his approval of a change for a life insurance company adopting generally accepted accounting principles. Examples of the disclosure required in the auditor's report under these circumstances are set forth in SAP No. 53.

Reliance on Actuaries

11.14 It has been the practice for some auditors to refer, in the opinion paragraph of their reports, to the role of the actuaries in various ways. In many instances, it has not been clear whether the auditor intended such reference as an indication of a division of responsibility (for example, as if between two auditors) or as an explanation of how the auditor had satisfied himself with respect to gathering of sufficient competent evidential matter related to policy reserves and other actuarially-determined amounts, referred to in this section collectively as "reserves."

11.15 As described in the section, "Utilization of Actuaries," in paragraphs 9.08 through 9.15, the auditor should avail himself of the competence of an actuary as he would use the expertise of other professionals. The auditor cannot diminish his responsibility to satisfy himself as to reserves by referring in his opinion to actuaries.

11.16 The use of actuarial expertise is a fulfillment of the auditor's responsibility for obtaining sufficient evidential matter in accordance with generally accepted auditing standards. The auditor must be satisfied with the reserves, but there is no requirement to explain how he was satisfied or to elaborate upon the steps he followed, including use of varying forms of expertise, in performing such tests of the accounting records and such other auditing procedures as he considered necessary in the circumstances. Reference to the assistance furnished by actuarial expertise in the opinion paragraph of the auditor's report should not be made unless it is the auditor's intention not to render an opinion on the financial statements taken as a whole. If, in fact, the auditor is unwilling to express an unqualified opinion because he has not satisfied himself as to the reserves and the changes therein, reference to the responsibility for the amounts of the reserves may be appropriate. Normally, under such circumstances, because of the materiality of reserves, the auditor should disclaim any opinion as to the fairness of the financial statements taken as a whole.

11.17 Accordingly, so that there may be no misunderstanding as to the significance of the use of actuaries insofar as it relates to the degree of responsibility being assumed by the auditor expressing an opinion on overall financial position and results of operation, it is considered preferable not to refer to the utilization of actuarial expertise in the scope paragraph. Such disclosure of the use of actuaries may be interpreted as an indication that the auditor making such reference had performed a more thorough audit than an auditor not making such reference, thereby implying an additional degree of assurance.

11.18 Since the foregoing defines or establishes procedures which go beyond current practice, it is not intended to be retroactive with respect to opinions which have been issued previously. Accordingly, where comparative financial statements are presented, it may be necessary for auditors to continue to make reference to actuaries in reports on earlier periods, but to omit such reference in subsequent reports. However, in those cases where reference in prior reports was not required because the auditor had satisfied himself as to reserves, it is suggested that such reference be omitted for all years.

Appendix A

Illustrative Financial Statements and Supplementary Data

Financial Statements

The following financial statements are presented as suggested examples of the format of financial statements which might be presented by a life insurance company reporting in conformity with generally accepted accounting principles. Further experience in the implementation of this guide may result in new and improved presentations.

ABC LIFE INSURANCE COMPANY
BALANCE SHEET
December 31, 197X and 7Y

ASSETS	197X	197Y
Cash and investments:		
Cash	$	$ ......
Bonds, amortized cost (market $.......)	....	....
Mortgages on real estate, amortized cost	....	....
Preferred stocks, cost (market $.......)	....	....
Common stock, market value	....	....
Policy loans	....	....
Real estate, cost (less $....... accumulated depreciation)	....	....
Investment in affiliated companies (state basis)	....	....
Other investments (state basis)	....	....
Total	....	....
Accrued investment income	....	....
Accounts receivable and agents' balances (net of $....... allowance for uncollectible accounts)	....	....
Property and equipment, at cost:		
Land	....	....
Buildings	....	....
Furniture and equipment	....	....
Less accumulated depreciation	....	....
Net property and equipment	....	....
Unamortized acquisition costs	....	....
Other	....	....
Assets held in separate accounts	....	....
Total assets	$	$ ......

(continued)

The accompanying notes are an integral part of these financial statements.

ABC LIFE INSURANCE COMPANY
BALANCE SHEET continued
December 31, 197X and 7Y

	197X	197Y
LIABILITIES		
Policy liabilities:		
Future policy benefits:		
Life and annuity	$	$ ......
Accident and health	....	....
Other	....	....
Unpaid claims	....	....
Dividends	....	....
Premium deposits	....	....
Unearned premiums	....	....
Other	....	....
Total	....	....
Income taxes	....	....
Real estate mortgages payable	....	....
Note payable	....	....
Accrued expenses	....	....
Other	....	....
Dividends to stockholders	....	....
Deferred income taxes	....	....
Undistributed earnings on participating business (Note 3)	....	....
Liabilities related to separate accounts	....	....
Total liabilities	....	....
STOCKHOLDERS' EQUITY		
Capital stock—authorized .... shares of $ .... par value issued and outstanding .... shares	....	....
Capital in excess of par value	....	....
Net unrealized investment gains	....	....
Retained earnings:		
Appropriated (describe purpose)	....	....
Unappropriated, including $....... in excess of statutory unassigned surplus	....	....
Total stockholders' equity	....	....
Total liabilities and stockholders' equity	$	$ ......

ABC LIFE INSURANCE COMPANY
STATEMENT OF INCOME *
For the Years Ended December 31, 197X and 197Y

	197X	197Y
Revenue:		
Premiums:		
Life and annuity	$	$ ......
Accident and health	....	....
Other	....	....
Investment income (Net of expenses of $.......) (Note 4)	....	....
	....	....
Benefits and expenses:		
Death benefits	....	....
Annuity benefits	....	....
Accident and health benefits	....	....
Increase in liability for future policy benefits (Notes 1 and 4)	....	....
Other (detailed as appropriate)	....	....
Decrease (increase) in deferred acquisition costs (Note 1)	....	....
Provision for policyholders' share of earnings on participating business (Note 3)	....	....
	....	....
Equity in income (loss) of unconsolidated affiliates, net of related income taxes of $.......	....	....
Income before income taxes, realized investment gains and losses, and extraordinary gain (loss)	....	....
Provision for income taxes:		
Current	....	....
Deferred	....	....
	....	....
Income before realized investment gains and losses and extraordinary gain (loss)	....	....
Realized investment gains and losses, net of related income taxes of $....... (Note 2)	....	....
Income before extraordinary gain (loss)	....	....
Extraordinary gain (loss)	....	....
Net income	$	$ ......
Per share:		
Income before realized investment gains and losses and extraordinary gain (loss)	$	$ ......
Realized investment gains and losses	....	....
Income before extraordinary gain (loss)	....	....
Extraordinary gain (loss)	....	....
Net income	$	$ ......

The accompanying notes are an integral part of these financial statements.

* FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* has significantly changed the presentation of realized gains and losses. The results of the changes will be illustrated in a future edition.

NOTES *

1. The increase in liability for future policy benefits may be reclassified between death benefits, annuity benefits, and accident and health benefits. In such cases, the resulting amounts would be captioned "Provision for surrender and death (annuity) (accident and health) benefits." Acquisition costs incurred may be reclassified as an offset to appropriate expense accounts and amortization may be similarly charged or treated as a separate item.

2. Until generally accepted accounting principles for investment gains and losses are more clearly defined, some companies may wish to exclude realized investment gains and losses from income. In such cases, the last item in the income statement should be designated "Income excluding realized investment gains and losses."

3. This caption is only applicable when dividends are not considered as a benefit in determining the liability for future policy benefits. Where dividends are considered as benefits, the caption in the operations statement should be described as "Dividends to policyholders".

4. A modification of the income statement presentation would reduce net investment income and the increase in liability for future policy benefits by required interest on funds accumulated.

* FASB Statement No. 97 has significantly changed the presentation of realized gains and losses. The results of the changes will be illustrated in a future edition.

ABC LIFE INSURANCE COMPANY
STATEMENT OF STOCKHOLDERS' EQUITY
For the Years Ended December 31, 197X and 197Y *

	Capital Stock	Capital in Excess of Par Value	Net Unrealized Investment Gains	Retained Earnings: Appropriated	Retained Earnings: Unappropriated	Total
Balance, beginning of year	$					$
Proceeds of sale of .... shares of capital stock						
Net income						
Increase (decrease)in un-realized investment gains						
Income taxes applicable to increase (de-crease) in unrealized in-vestment gains						
Dividends to stockholders						
Addition to group contin-gency reserves						
Other (detailed as appropri-ate)						
Balance, end of year	$					$

The accompanying notes are an integral part of these financial statements.

* Similar data should be presented for all years reported.

ABC LIFE INSURANCE COMPANY
STATEMENT OF CHANGES IN FINANCIAL POSITION *
For the Years Ended December 31, 197X and 197Y

	197X	197Y
Resources provided:		
Income before extraordinary item	$	$ ......
Decreases (increases) in income not affecting resources:	....	....
Increase in liability for future policy benefits	....	....
Amortization of deferred acquisition costs	....	....
Deferred income taxes	....	....
Other (detailed as appropriate)	....	....
Resources provided by operations before extraordinary item	....	....
Extraordinary item	....	....
Resources provided by operations	....	....
Bonds sold or matured	....	....
Preferred stocks sold	....	....
Common stocks sold	....	....
Repayments on mortgage loans	....	....
Repayment on policy loans	....	....
Other (detailed as appropriate)	....	....
Total	$	$ ......
Resources applied:		
Investment in bonds:	$	$ ......
Long-term	....	....
Temporary (net)	....	....
Mortgage loans	....	....
Investment in preferred stocks	....	....
Investment in common stocks	....	....
Policy loans	....	....
Acquisition costs	....	....
Dividends to stockholders	....	....
Other (detailed as appropriate)	....	....
Net increase (decrease) in cash	....	....
Total	$	$ ......

The accompanying notes are an integral part of these financial statements.

* [Note—FASB Statement No. 95, *Statement of Cash Flows,* as amended supersedes APB Opinion 19, *Reporting Changes in Financial Position,* and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position.]

Supplementary Data*

The following statements are illustrative of the form for supplementary data required to reconcile net income and stockholders' equity presented in financial statements prepared in accordance with regulatory practices to such amounts determined in conformity with generally accepted accounting principles. As an alternative, the necessary details may be set forth in a note to the financial statements or within the financial statements themselves as adjustments to the surplus and income statements.

Where a reconciliation of net income and stockholders' equity presented in financial statements prepared in conformity with generally accepted accounting principles to such amounts determined in accordance with regulatory practices is required by law or regulation, a similar format may be used.

*The supplementary data required to reconcile net income and stockholders' equity in accordance with regulatory practices to such amounts determined in conformity with GAAP is no longer required. See FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*.

Statement of Adjustments to Arrive at Net Income *

	197X	197Y
Net gain (loss) from operations as shown in the accompanying Statement of Operations (Regulatory basis)	$	$ ......
Adjustments (to be added or deducted as appropriate):		
Adjustments to policy reserves	....	....
Change in deferred acquisition costs	....	....
Adjustments arising from special reinsurance agreements	....	....
Deferred income taxes applicable to adjustments to policy reserves and deferred acquisition costs and special reinsurance agreements	....	....
Equity in undistributed earnings of unconsolidated subsidiaries, net of related income taxes $.......	....	....
Income, excluding realized investment gains and losses	....	....
Realized investment gains and losses, net of related income taxes of $.......	....	....
Net income	$	$ ......
Per share:		
Income excluding realized investment gains and losses	$	$ ......
Realized investment gains and losses	....	....
Net income	$	$ ......

* The supplementary data required to reconcile net income and stockholders' equity in accordance with regulatory practices to such amounts determined in conformity with GAAP is no longer required. See FASB Statement No. 60.

Statement of Adjustments to Arrive at Stockholders' Equity *

	197X		197Y	
Capital stock and surplus as shown in the accompanying balance sheet (Regulatory basis)		$		$ ......
Adjustments (to be added or deducted as appropriate):				
Adjustments to policy reserves	$		$	
Deferred acquisition costs	....		....	
Adjustments arising from special reinsurance agreements	....		....	
Nonadmitted assets	....		....	
Mandatory securities valuation reserve	....		....	
Deferred income taxes applicable to:				
Adjustments to policy reserves, deferred acquisition costs, and special reinsurance agreements	....		....	
Net unrealized gains on investments	....		....	
Other	....	....	....	....
Stockholders' equity		$		$ ......
Consisting of:				
Capital stock		$		$ ......
Capital in excess of par value		....		....
Unrealized investment gains or losses		....		....
Retained earnings:				
Appropriated for contingencies — prescribed or voluntary	$		$	
Mandatory securities valuation reserve	....		....	
Unappropriated	....	....	....	....
		$		$ ......

* The supplementary data required to reconcile net income and stockholders' equity in accordance with regulatory practices to such amounts determined in conformity with GAAP is no longer required. See FASB Statement No. 60.

Notes to Financial Statements

An illustrative note describing some of the common differences between regulatory practices and generally accepted accounting principles is as follows: *

> The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .... which vary in some respects from generally accepted accounting principles. The more significant of these differences are as follows: (a) acquisition costs, such as commissions and other costs in connection with acquiring new business, are charged to current operations as incurred, whereas the premiums are taken into earnings over the premium paying period of the policies; (b) policy reserves are based on statutory mortality and interest requirements and without consideration of withdrawals, which may differ from reserves based on reasonably conservative estimates of mortality, interest, and withdrawals; (c) deferred income taxes are not provided for unrealized gains on investments, differences in reporting policy reserves, and other material book-tax timing differences; (d) a liability for undistributed earnings allocable to participating policyholders has not been recorded; (e) the mandatory securities valuation reserve is reported as a liability rather than as an appropriation of surplus; (f) certain assets designated as "nonadmitted assets" (principally furniture and equipment, agents' debit balances, and certain other classes of receivables) have been charged to surplus.
>
> The effects of these differences on stockholders' equity and net income are shown in the accompanying supplemental statements of adjusted net income and adjusted stockholders' equity.

Ordinarily, the effects of these differences on the statement of changes in financial position ** need not be disclosed because they will not affect the flow of funds.

In addition to those matters discussed in the foregoing illustration, other differences between regulatory accounting practices and generally accepted accounting principles may exist which will require disclosure. Among other things, such disclosure might include methods of accounting for investments in affiliates, prior service costs of pension plans, stock dividends, and reserve strengthening, or other matters related to financial statement classification or presentation. Other differences from generally accepted accounting principles may exist with respect to a particular company, but which may not be unique to the life insurance industry. These, of course, will have to be dealt with by the independent auditor as they arise.

In those cases where the supplementary data are to be included in the notes, the concluding paragraph of Note 1 might read, "The effect of these differences on the financial statements is shown (below) in the accompanying tabulations." Such tabulations would be presented in the same form as the preceding examples of supplementary statements of adjustments to arrive at net income and stockholders' equity.

The foregoing material attempts to set forth the most significant differences which are peculiar to life insurance regulatory accounting. Further, it would be preferable to avoid stating the per share amounts based on regula-

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* In a change to what is considered generally accepted accounting principles, this note is generally no longer presented.

** [Note—FASB Statement No. 95, *Statement of Cash Flows,* as amended supersedes APB Opinion 19, *Reporting Changes in Financial Position,* and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position.]

tory statements where the auditor's opinion indicates that net income is not in accordance with generally accepted accounting principles.

Appendix B

Accounting for Unamortized Acquisition Costs

As indicated in Part II of this guide, acquisition expenses should be charged against income in proportion to premiums recognized. Examples of methods for amortizing such costs are set forth below.

Some techniques will tend to produce unacceptable results. For example, amortization of costs on the basis of "average policy life" involving a straight-line charge-off of a fixed sum per policy per year plus an immediate charge-off of the unamortized amounts attributable to terminated policies, will not result in a reasonable association of expenses with related revenues.

Assume 1,000 policies are issued with a total acquisition cost of $60,000 and that the "average life" of a policy was determined to be three years so that $20 per policy in force would be written off each year with the unamortized balances for each policy being charged off for those policies terminating. Under this approach amortization would occur as follows:

Year	Policies in Force Beg. of Year (1)	Termi-nations (2)	Policies in Force End of Year (3)	Annual Amortization For Policies in Force (Col 3 x $20) (4)	Write-off of Unamortized Balances on Policies Term. (5)	Total Amortization (6)	Expected Premium Income (7)
1	1,000	200	800	$16,000	(a)$12,000	$28,000	$100,000
2	800	200	600	12,000	(b) 8,000	20,000	80,000
3	600	200	400	8,000	(c) 4,000	12,000	60,000
4	400	200	200	—	—	—	40,000
5	200	200	—	—	—	—	20,000
						$60,000	

(a) 200 × $60; (b) 200 × $40; (c) 200 × $20

This method does not result in amortizing costs in proportion to premium revenue. It is also inconsistent with the concept that aggregate acquisition costs for each year's blocks of business are expected to be recovered from the aggregate premium revenue over the life of each block. Stated otherwise, the cost of *each* individual policy issued cannot be expected to be recovered from *each* policy's premium revenue, since it is known at the outset that terminations will begin almost immediately with respect to any year's block of business.

A more refined approach would involve the use of an amortization schedule adopted for each major category of business in the year of issue. Amortization would be prescheduled to coincide with the expected premium revenue as shown below:

Year	*Expected Premium Revenue*	*Ratio of Annual to Total*	*Prescheduled Amortization*	*Ratio of Amortization to Premium Revenue*
1	$100,000	33.3%	$20,000	20%
2	80,000	26.7	16,000	20
3	60,000	20.0	12,000	20
4	40,000	13.3	8,000	20
5	20,000	6.7	4,000	20
	$300,000	100.0%	$60,000	20%

This method results in amortizing costs in proportion to premium revenues. Some characterize this as the "sum-of-the-premiums" method. If the persistency experience differs from that expected, actual premium revenues will differ from those estimated. Accordingly, the amount of amortization in any year will be disproportionate to premium revenue. The method could be modified so that annual or periodic adjustments could be made to give effect to actual terminations. Because of the volume of schedules that would be required for each year's new business, this technique may be impractical.

Another method approximates the technique used by actuaries in the determination of reserve valuation factors under the single valuation reserve method. This method uses a "standard unamortized cost factor" or "expense reserve factor" which is applied to the insurance in force at the end of each period. Using the prescheduled amortization from the previous example, the "expense reserve factor" is determined as follows:

Year	*Planned Amortization*	*Planned Unamortized Cost End of Period*	*Expected Insurance in Force End of Period (000)*	*Planned Unamortized Cost Per M of Ins. in Force*
1	$20,000	$40,000	$800	$50
2	16,000	24,000	600	40
3	12,000	12,000	400	30
4	8,000	4,000	200	20
5	4,000	-0-	-0-	0
	$60,000			

Assume that actual experience emerges as follows:

Year	Actual Premium Revenue	In Force End of Period (000)	Planned Unamortized Cost Per M Ins. in Force	Unamortized Cost End of Period	Amortization	
					Amount	Ratio to Premiums Collected
1	$ 100,000	700	$50	$35,000	$25,000	25%
2	70,000	600	40	24,000	11,000	16
3	60,000	500	30	15,000	9,000	15
4	50,000	300	20	6,000	9,000	18
5	30,000	0	0	-0-	6,000	20
	$ 310,000				$60,000	

Under this method, if persistency is higher or lower than assumed, the unamortized cost factors (or "expense reserve factor") are multiplied by higher or lower in-force amounts. Thus, the method tends to provide some degree of self-correction in that it causes the rate of amortization to increase or decrease as actual persistency is lower or higher than initially estimated. If actual experience differs significantly from that assumed, the factors should be recomputed.

To be fully consistent with actuarial concepts, the rate of amortization should give effect not only to estimated persistency, but to the interest assumed in benefit reserve calculations. In the previous examples, an amount of $20 per thousand would have to be included in the gross premium in order to recover first-year acquisition costs based on expected persistency. This may be determined as follows:

Year	Policies Expected to Be in Force at Beginning of Each Year
1	1,000
2	800
3	600
4	400
5	200
Total expected premium payments	3,000
Acquisition costs	$60,000

Amount required per premium payment $60,000 ÷ 3,000 = $20

This $20 may be considered as the present value of expected future expense premiums. The premium actually calculated and charged should be increased by the time cost of the funds expended. An interest rate, which coincides with the basic interest assumption, is used to determine an annuity factor. This factor is used to determine the expense portion of the gross premium in the following tabulation:

Year (1)	Expected in Force Beg. of Year (2)	Interest Rates (3)	Interest Present Value Factor (4)	Present Value of 1 (Due at Beg. of Each Year) at the Beg. of Year 1 (2 × 4) (5)
1	1.0	.06	1.000	1.000
2	.8	.06	.943	.754
3	.6	.05	.890	.534
4	.4	.05	.848	.339
5	.2	.05	.807	.161
				2.788

The annuity for the premium paying period is 2.788 which, when divided into the initial acquisition cost of $60 per policy, gives an expense premium of $21.51. The total of $21.51 paid at the beginning of each year by the expected number of survivors is equivalent to $60 at the time of issuance of the policy plus interest thereon at the assumed rates for the collection period indicated. This example demonstrates how premiums are theoretically determined and the basis upon which the expense portion of a single valuation premium factor would be determined. Any "worksheet" approach to amortization should be based on the fact that interest affects the rate of recovery of costs. This is a refinement of the previous example and results in a worksheet determination of an expense reserve factor which would be identical to the expense portion of the single reserve valuation factor. The following tabulation summarizes this method:

Year	Expected in Force Beginning of Year (1)	Interest Rate (2)	Unamortized Cost Beginning of Year (3)	Expense Premium Payment $21.51 × (1) (4)	Portion of Premium Representing: Interest [(3)-(4)] × (2) (5)	Portion of Premium Representing: Cost Recovered (4)-(5) (6)	Unamortized End of Year: Amount (3)-(6) (7)	Unamortized End of Year: Per in Force at End of Year (8)
1	1.0	6%	$60.00	$21.51	$2.31	$19.20	$40.80	$51.00
2	.8	6	40.80	17.21	1.41	15.80	25.00	41.67
3	.6	5	25.00	12.91	.60	12.31	12.69	31.72
4	.4	5	12.69	8.60	.21	8.39	4.30	21.50
5	.2	5	4.30	4.30	-0-	4.30	-0-	-0-
						$60.00		

The factors shown in column 8 would be applied to the insurance in force at the end of each year in the manner shown in the previous example. When amortization is determined by this method, a result is produced which is identical to the result that would be produced by a single reserve valuation factor used to determine a single sum representing the aggregate amount of policy benefits and unamortized acquisition costs.

Appendix C

Deferred Income Taxes*

Life Insurance Taxation**

Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959. The Act contemplated taxation of total income, but the computation of tax is complex because of the manner in which total taxable income is segmented between investment income, gain from operations and policyholders' surplus (gain from operations previously excluded from tax) and the interrelationship of these elements. Total taxable income composed of those three elements, referred to as Phase I, Phase II, and Phase III income, is subject to tax in the same manner as other corporations, including alternative tax computation for capital gains, foreign tax credit, and investment credit. However, an operations loss deduction (the equivalent of a net operating loss carryover) is treated as a deduction from gain from operations in arriving at taxable income. The terms Phase I, Phase II, Phase III, and combinations thereof are frequently used to describe the specific situations in which companies are taxed. There is a lack of uniformity in the use of these terms; therefore, their use has been avoided in describing various taxable situations in this appendix.

Taxable investment income consists of that portion of investment yield (gross investment income less investment expenses) deemed not required to maintain reserves ("company's share") reduced by a proportionate share of tax exempt interest and dividends-received deduction. The portion of investment yield which is considered to be required to maintain reserves ("policyholders' share") is the sum of (1) the lower of the average or current earnings rate ("adjusted reserves rate") applied to mean life insurance reserves adjusted to reflect the effect of the difference between the adjusted reserves rate and the assumed rate actually used to calculate reserves, (2) the current earnings rate applied to mean pension plan reserves, and (3) interest paid during the year.

Gain or loss from operations consists of all income and cost, including investment income, with limitation on deductibility of dividends to policyholders and certain other special deductions described later herein. Investment income for this purpose is net of the policyholders' share computed using rates of interest assumed in calculating reserves as opposed to adjusted rates used in determining taxable investment income. However, this is offset in the reserve increase with no effect on income. Taxable income consists of taxable investment income and 50% of the amount by which gain from operations exceeds taxable investment income. If gain from operations is less than taxable investment income, the lesser amount is taxable income. If there is a loss from operations, there is no taxable income except to the extent of any reductions from policyholders' surplus.

The 50% portion of gain from operations which is excluded from taxable income, together with the amount of special deductions for certain accident and health, and group life insurance and nonparticipating contracts is added to the policyholders' surplus account until the total policyholders' surplus

* [Note—FASB Statement No. 109, *Accounting for Income Taxes,* is effective for fiscal years beginning after December 15, 1992. It supersedes APB Opinion No. 11, *Accounting for Income Taxes,* and FASB Statement No. 96, *Accounting for Income Taxes.*]

** There have been several rather significant revisions to taxation of life insurance companies since this guide was originally issued. A current discussion of life insurance taxation will be provided in a future revision.

account equals a specified maximum. Reductions in this account are included in taxable income in the year when such reduction occurs. Reductions in this account arise when the company (a) makes distributions, in excess of shareholders' surplus, to stockholders as dividends or in redemption of stock in partial or complete liquidation, (b) accumulates policyholders' surplus in excess of the specified maximum, (c) elects to transfer amounts to shareholders' surplus, or (d) ceases to qualify as a life insurance company for tax purposes.

Dividends to Policyholders and Special Deductions

The Life Insurance Company Income Tax Act of 1959 provides deductions for dividends to policyholders and special deductions for certain accident and health and group life contracts, and nonparticipating contracts.

Deductions for dividends to policyholders generally enter into the determination of taxable income and pretax accounting income. Such deductions may represent timing differences when the amounts deducted in the financial statements differ from the amounts deducted in the tax return.

The special deductions for nonparticipating contracts and accident and health and group life contracts do not enter into the determination of pretax accounting income in any period. Deductions for nonparticipating contracts are based on a percentage of increase in reserves or a percentage of total premiums, whichever produces the larger deduction. When based on a percentage of increase in reserves, the deduction may be directly affected by other timing differences related to the calculation of reserves. However, when based on a percentage of total premiums, the deductions may be unaffected by other timing differences related to the calculation of reserves. Deductions for accident and health contracts are based on a percentage of annual premiums subject to a cumulative limitation. Such deductions are not directly affected by other timing differences.

Limitations have been placed on the aggregate of all the foregoing deductions which prevent the reduction of gain from operations to an amount which is less than taxable investment income minus $250,000. When gain from operations, computed without regard to such deductions, is less than taxable investment income, the aggregate of these deductions is limited to $250,000. When such deductions are limited, the unused deductions are not available in subsequent periods.

Categories of Taxation

If gain from operations, after deducting all dividends to policyholders and special deductions described above, is less than taxable investment income by more than $250,000, these dividends to policyholders and special deductions are limited to an amount which will not decrease gain from operations below this level. As long as taxable income is $250,000 less than taxable investment income and all of the dividends or special deductions have not been used in arriving at taxable income, the tax base is taxable investment income less $250,000, not gain from operations. For a company which remains in this category, any timing difference affecting only gain from operations as a result of applying generally accepted accounting principles will have no tax effect when it reverses. This situation is described as category 1 on the table in this Appendix.

If gain from operations, without regard to dividends to policyholders and special deductions, is less than taxable investment income, the aggregate of these special deductions is limited to $250,000. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. However, the unused special deductions may, in some cases, be used in calculating the tax effects of timing differences as described under "computational techniques." This situation is described as category 2 on the table in this Appendix.

Gain from operations, without regard to dividends to policyholders and special deductions, may be less than taxable investment income, and the aggregate of these special deductions may be less than $250,000 so as not to be limited. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. This situation is described as category 3 on the table in this Appendix.

Gain from operations, without regard to dividends to policyholders and special deductions, may be greater than taxable investment income and, if the aggregate of these special deductions does not reduce gain from operations to an amount which is less than taxable investment income or which is not $250,000 less than taxable investment income, these special deductions are not limited. For companies which remain in these categories, the tax base is gain from operations, and timing differences will produce tax effects which reverse. These situations are described as categories 4 and 5 on the table in this Appendix.

Significant timing differences and their effects on special deductions in a "with-and-without" calculation could result in a current change in category. Methods for dealing with such a situation and for determining or dealing with the tax effects of timing differences in general are discussed under "Computational Techniques."

	Taxable investment income	Gain from operations before special deductions	Special deductions: Total	Special deductions: Allowable	Special deductions: Unused	Taxable income
Category 1	$1,000,000	$1,500,000	$1,200,000	$ 750,000	$ 450,000	$ 750,000
Category 2	1,000,000	900,000	1,200,000	250,000	950,000	650,000
Category 3	1,000,000	900,000	200,000	200,000	—	700,000
Category 4	1,000,000	3,000,000	1,200,000	1,200,000	—	1,400,000*
Category 5	1,000,000	2,100,000	1,200,000	1,200,000	—	900,000

* Taxable investment income		$1,000,000
Gain from operations after special deductions	$1,800,000	
Less taxable investment income	1,000,000	
Excess	$ 800,000	
50% of excess included in taxable income		400,000
Taxable income		$1,400,000

Nature of Timing Differences

While the usual timing differences, such as those resulting from depreciation methods, amortization of bond discount, and accrual of dividends and interest may exist for life insurance companies, the most significant timing differences result from the adoption of generally accepted accounting principles—principally from differences between adjusted life insurance reserves and those used for tax purposes and deferral and amortization of acquisition costs. Such timing differences affect only gain from operations.

The only transactions that give rise to timing differences with respect to taxable investment income would be those related to the timing of the inclusion of items of investment income or investment expense, such as cash vs. accrual basis of accounting for dividends and interest or accelerated vs. straight-line depreciation methods on real estate. While the inclusion of adjustments to life insurance reserves and deferral and amortization of acquisition costs resulting from the adoption of generally accepted accounting principles in a hypothetical tax return would indirectly affect taxable investment income, such effect is a permanent difference. These items affect only total assets or aggregate reserves, which amounts will, for income tax purposes, always be greater or less than comparable amounts for accounting purposes. Accordingly, amounts of such differences do not reverse in subsequent periods.

Computational Techniques

As stated in APB Opinion No. 11, *Accounting for Income Taxes,* "The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax action creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future period." "With-and-without" computations for life insurance companies are more complicated than is the case in the normal tax return because of the complexities of the Life Insurance Company Income Tax Act of 1959. Accordingly, no short-cut method of computing deferred income taxes is possible.

The differential tax effect tentatively determined in the with-and-without calculation must be further examined to determine whether such tax effect will reverse in the future. For example, as discussed previously, timing differences affecting only gain from operations may result in a current tax effect in such a with-and-without calculation which may not reverse in the future for companies who continue to be taxed on taxable investment income. Deferred taxes are not required to be provided for the current tax effect of timing differences if circumstances indicate that there will not be a reversal of such current tax effect in the future.

Although (1) certain special deductions never enter into the determination of pretax accounting income in any period and/or (2) the amount of dividends to policyholders and certain special deductions may be subject to limitation on the tax return so that unused deductions will not be available in subsequent periods, such deductions may be properly recomputed in the with-and-without calculation. For example, unused dividends to policyholders and special deductions may be used to offset timing differences which affect taxable income to the extent that the limitations on these deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from such timing differences will not be offset by like deductions when they reverse. Similarly, in the case of provisions for dividends to policyholders, which are timing differences themselves, statutory limitations should not be applied so as to eliminate their current tax effect unless circumstances indicate that such dividends will be limited when they reverse.[7] Special deductions that are directly affected by timing differences should be recomputed in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when such timing differences reverse.

Companies adopting generally accepted accounting principles for the first time will be required to reflect such change retroactively in the year of change. This retroactive change will apply to all of the adjustments necessary to present financial statements in conformity with generally accepted accounting principles, including the application of deferred income tax accounting. Since the adjustment will be applied retroactively, the restriction on the use of the "net change method" described in APB Opinion No. 11 will not be applicable. The intent of the restriction was to preclude a company that was not applying interperiod tax allocation prior to the Opinion from using the tax effect of the reversal of a difference to offset deferred taxes required to be recognized for current originating timing differences. Accordingly, a life insurance company adjusting retroactively will be able to use the individual transaction, gross change, or net change methods.

From a practical standpoint, the gross change method may be very difficult to apply to timing differences related to reserves. Companies that elect this method must maintain detailed records of originating and reversing differences or must be prepared to demonstrate, by use of modelling or other techniques, that reasonable approximations of originating and reversing timing differences have been made.

Because of the complexity of life insurance income tax computations, the net change and gross change methods can produce substantially different results. For the purpose of using the gross change or net change methods, adjustments to reserves and the deferral and amortization of acquisition costs constitute similar timing differences which could be grouped. While reserves and deferred acquisition costs will be segregated in the balance sheet, their grouping for the purpose of determining pretax accounting income is justified because of their interrelationship and similar reversing characteristics. In addition, grouping of other timing differences may be most appropriate because separate treatment of individual timing differences can produce results which vary significantly from those that would result from the grouping of all timing differences. These different results are produced when the with-and-without calculation causes a change in category of taxation.

When results are produced which vary significantly from the company's current tax status because of the method used or the grouping or separate treatment of timing differences, consideration must be given to the reversal of the tax effects calculated. In determining whether there will be any future tax effect, the reversing characteristics of the timing differences must also be considered. Deferred taxes need not be provided unless such taxes will reverse in the future, and a change in category of taxation resulting from the with-and-without calculation should not be recognized unless circumstances indicate that such change in category will result when the timing difference reverses.

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[7] For purposes of computing deferred taxes, it will be necessary to identify the amount of dividends to policyholders deducted in the financial statements even when they are considered as benefits in the reserving method.

When the reversal of tax effects cannot be reasonably determined, deferred income taxes should be provided based on the differential computed using a with-and-without calculation as if the company's tax return was filed on the basis on which financial statements were prepared, including any resulting change in phase of taxation. In such cases, special deductions which are not timing differences or which are not affected by other timing differences and, therefore, do not reverse, should be limited to amounts calculated in the tax return.

Changes in Circumstances

If deferred income taxes have not been provided on timing differences on the presumption that such timing differences will have no tax effects when they reverse, and circumstances change so that it becomes apparent that tax effects will result, a company should accrue as an expense of the current period income taxes attributable to those timing differences; income tax expenses for such timing differences should not be accounted for as an extraordinary item.

If deferred income taxes have been provided on timing differences, and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, deferred income taxes previously accrued should be included in income only as the related timing differences reverse.[8]

The facts and circumstances known about the company's income tax position in prior years and the current year must be considered, together with any changes which have affected or are expected to affect income taxes. Long range forecasts may also be useful. Examples of changes in circumstances which might indicate the need for adjusting tax accounts would include the following:

1. Change in volume and/or profitability of business.
2. Change in mix of health insurance and life insurance.
3. Change in mix of participating and nonparticipating business.
4. Change in dividends to policyholders.
5. Acquisition or disposition of subsidiaries.
6. Change from rental to ownership of home office building.
7. Adopting of tax planning techniques such as the Section 818 (c) reserve strengthening election.

Policyholders' Surplus

APB Opinion No. 23, *Accounting for Income Taxes—Special Areas,* states that deferred taxes should not be provided on amounts designated as policyholders' surplus on the tax return of a stock life insurance company unless circumstances indicate that the insurance company is likely to pay income taxes, either currently or in subsequent years, because of known or expected reductions in policyholders' surplus.

Pre-1958 Timing Differences

Prior to the enactment of the Life Insurance Company Income Tax Act of 1959, which was effective for 1958, life insurance companies were taxed on investment income. Accordingly, most of the retroactive adjustments to conform to generally accepted accounting principles will create timing differences that would have had no tax effect prior to 1958 and, therefore, no deferred

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[8] Amortization procedures described in paragraph 10 of *Accounting for Income Taxes—An Interpretation of APB Opinion No. 11,* Donald J. Bevis and Raymond E. Perry, AICPA, 1969, should be followed.

income taxes should be provided for cumulative timing differences at January 1, 1958.

Discounting

Representatives of industry have proposed that discounting should be applied to unamortized deferred income tax balances. It has been stated that such discounting is consistent with the discounting of other liabilities in a life insurance company. However, the application of discounting would be applicable only under the liability method of accounting for deferred income taxes, which method was rejected by the Accounting Principles Board in Opinion No. 11.

Summary

As stated in APB Opinion No. 11, "the principal problems in accounting for income taxes arise from the fact that some transactions affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. . . . A major problem is . . . the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income." Tax effects are defined principally as "differentials in income taxes of a period attributable to . . . revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income of another period . . .." The opinion further states that, "interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences," and that, "deferred tax amounts reflect the tax effects which will reverse in the future."

The foregoing language has been interpreted in this appendix to mean that interperiod tax allocation procedures should account for reversal of timing difference *and the reversal of their tax effects*. Accordingly, the calculation in the current period of the tax effect of a timing difference measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income must be reviewed to determine whether circumstances indicate that the tax effect so measured will reverse in the future when the timing difference reverses. This appendix describes some of the more obvious situations where there may be no reversal of effects measured by means of a with-and-without calculation and suggests that deferred taxes are not required to be provided if circumstances indicate that the tax effects so measured will not reverse in the future.

Because of the complexity of life insurance company taxation, it was not practical to discuss all the situations that might occur. Further experience will develop new situations and solutions thereto.

Appendix D

Supplementary Internal Control Structure Questionnaire for Life Insurance Companies

This questionnaire is included herein to provide examples of the type of questions (in addition to those found in a general internal control structure questionnaire) that might be asked by the auditor in obtaining an understanding of the internal control structure of a life insurance company. It is not a complete questionnaire and must be augmented, modified, and adapted for a particular life insurance engagement. The questions are intended to create an awareness of the broad range of controls required by an insurance company because of its underwriting and investment activities. Additional questions will be required where a specific company issues contracts for other than ordinary life or accident and health business. It follows, therefore, that a more effective internal control structure questionnaire can be designed by the auditor to suit his needs in a specific client situation. Also, there are areas not covered by this questionnaire which must be reviewed by the auditor that are not peculiar to the insurance industry; namely, the internal audit and electronic data processing functions.

The questions are basically designed so that a "yes" response would generally indicate satisfactory conditions, while a "no" response would indicate a weakness to be considered in determining the nature and extent of audit procedures and tests to be employed.

General

1. Is the general accounting department completely separated from:
   a. Agency department?
   b. Claim or benefit department?
   c. Underwriting department?
   d. Investment department?
   e. Premium accounting department?
2. Are schedules used by client in preparation of accrual basis statements for inclusion in Annual Statement filed with regulatory insurance departments reviewed by someone other than the person preparing these papers?

   Reviewer . . . .

   Title . . . .

Cash Receipts

1. Is access to daily mail cash receipts denied to persons with the following responsibilities:
   a. Authorize return premiums?
   b. Prepare or record the billings?
   c. Maintenance of securities records?
2. Are cash funds other than cash receipts handled by someone other than the cashier?
3. Are securities handled by someone other than the cashier?

4. Where the company utilizes the debit system of collecting premiums on certain policies, are collections by agents deposited daily to bank accounts under home office control?
5. If the company accepts postdated checks or drafts for later deposit as premiums become due:
   a. Are they under the control of someone other than the cashier who does not have access to cash receipts?
   b. Does the system of safekeeping provide for timely deposit of the check or proceeds of the draft?

Cash Disbursements

1. Are drafts used for payment of:
   a. Benefits and claims?
   b. Dividends to policyholders?
   c. Medical fees?
   d. Other items?
   Identify . . . .
2. Are drafts recorded when issued?

Securities

1. Are security transactions authorized by:
   a. The board of directors?
   b. The investment committee?
   c. An officer?
   d. Other?
2. Does release of securities require the signatures of more than one officer where securities are under:
   a. Control of a safekeeping bank or independent custodian?
   b. Dual control of two officers other than those authorized to sign the release?
3. Are the securities periodically inspected or confirmed with independent custodians and balanced with security records?
   a. By internal auditors?
   b. By executives?
   c. By others?
4. Is the investment portfolio reviewed by an executive with the responsibility for determining that investments are in compliance with the State insurance code?

Mortgage Loans

1. Are direct loans and purchases of existing mortgages authorized by:
   a. An investment committee or the board of directors?
   b. Someone else? . . . .
2. Are independent appraisals required to assure the loan is within legal limits and company policy?
3. For loans serviced by correspondent servicers:
   a. Are periodic trial balances of loans received and balanced to company's records?
   b. Are external audits made of the records of the servicer?

c. Does the company's internal audit staff examine the records of the servicer?

Policy Loans

1. Is the amount of the policy loan checked against the cash surrender value at the date of the loan?
2. Is the in-force status of the policy checked before the policy loan is approved?
3. Does the company notify policyholders when the automatic loan provision is applied?
4. Are policy loan records checked for status of loans before any policy surrender or death benefits are paid?

Real Estate

1. Is investment committee approval required for:
   a. Purchases, sales and leases of real estate for investment purposes?
   b. Setting the sales price for previously foreclosed property?
   c. Renovations or improvements to real estate owned?
   d. Determination of the amount to be considered as rental income on real estate owned and used by the company?
2. If investment properties are being managed for the company by independent agencies, are such manager's records reviewed periodically by the internal audit staff or other company representatives to determine the propriety of expenses and to account for income?

Miscellaneous Assets

1. Are details of the cost and accumulated depreciation for furniture, equipment and automobile, and similar nonadmitted assets maintained and controlled by general ledger accounts or schedules evidencing control balances balanced to amounts included in financial statement balances?
2. Are established procedures in effect for authorizing advances to agents?
3. Do contracts with agents reflect company policy as to financing arrangements?
4. Are IRS form 1099s filed on agents' balances charged off and on the value of agency prizes and awards given to agents?

Policy Liabilities (policy valuation reserves)

1. Does the company maintain insurance in-force transaction registers and use such registers to reconcile insurance in force to corresponding totals of number and amounts of policies shown in valuation summaries?
2. Does the company have provisions for reviewing the reasonableness of life reserves and the yearly changes by reference to plan, year, and age-at-issue valuation analyses?
3. Does the company match data contained in the valuation file with corresponding data in the following records:
   a. Application file?

b. Premium record file?
c. Premium billing file?
d. Dividend file?
e. Other files? . . . .

4. Were the following items included in the comparison?
   a. Policy number?
   b. Policy plan?
   c. Year of issue?
   d. Age at issue?
   e. Amount?
   f. Mode of payment?
   g. Paid to date?
5. Does the company make other checks as to the completeness or accuracy of the in-force file?
6. Are the reserve factors and calculations checked?
7. Does the company utilize consulting actuaries to review or verify reserve valuations? Identify.
8. Do the consulting actuaries test the accuracy of the in-force listings and other summary items relied on in calculating policy reserves?
9. Does the company check the reasonableness of the "tabular cost" and "tabular net premiums" with respect to its ordinary life business?
10. Does the company establish active life reserves on noncancellable or guaranteed renewable A&H contracts?

Policy Forms and Issue

1. Is the security of unused forms adequately safeguarded?
2. When policies are issued, are they properly recorded in a register or other control?
3. Are all numbers accounted for?
4. Are procedures in effect, such as use of a checkoff list, to determine that all underwriting and credit reviews have been satisfactorily completed prior to policy issue?
5. Are policy forms approved by State insurance departments?
6. Are insurance contracts issued only upon receipt of the initial premium?
7. Are contracts returned and properly voided if the initial premium is not received?
8. Are voided contracts retained for subsequent inspection?

Premium Income

1. Are the records from which premium billings are prepared reconciled periodically with in-force insurance listings?
2. Are premiums billed, but not collected, kept under ledger control?
3. Does a person not having access to cash control the records used for preparation and mailing of:
   a. Premium notices?
   b. Lapse notices?

4. Do copies of lapse notices go to another person not under the direction of the premium department for follow-up?
5. Does the system provide for prompt notification to policyholders of application of automatic premium loans or other benefits to the payment of premiums?
6. Are cash receipts and premium income balanced monthly to premium registers?

Policy Benefits

1. Prior to payment of benefits, are claims department personnel required to check:
   a. The in-force status of policies?
   b. Amounts of policy loans deductible from benefits?
   c. Existence of other deductible items?
   d. Policy coverage of claimed benefit?
   e. Policy amounts applicable to claim?
   f. Receipt of all claim documents with indication of review and approvals?
2. If drafts are used in payment of benefits:
   a. Is control exercised over unissued drafts?
   b. Are issued and outstanding drafts accounted for?
   c. Is documentation reviewed in support of payments by supervisory personnel other than the claims department?
3. Do internal procedures provide for periodic comparison, by someone independent of the claim department, of endorsements on cancelled checks issued for policy benefits with signatures on policy applications?
4. Are the statistical totals of claims paid by policy maintained and reconciled with cashier and accounting department totals?
5. When claims are paid or drafts accepted, are procedures in effect for:
   a. Recording the reinsurance recoverable?
   b. Cancelling the estimated claim and estimated recoverable reinsurance?
6. Are paid claim documents routed to the accounting department for billing and recording reinsurance recoverable under facultative and treaty contracts?
7. Does the system provide for the accumulation of claims paid that might result in recoveries under excess contracts?
8. Are procedures in effect to provide reviews for amounts recoverable from reinsurance?
9. Is paid up and extended insurance calculated and reviewed by someone not involved in the premium collection procedure?
10. Are the amounts accrued or paid for dividends to policyholders on all lines of business reviewed and tested for compliance with company policy?
11. Is there a procedure for review of interest earned and credited on policyholder dividends or other policy benefits left on deposit as to compliance with rates approved by the board of directors?

Reinsurance

1. Is there a departmental responsibility for the review of policy issues to determine compliance with the limits established by the company's retention or acceptance of liability on any one life? Identify.
2. Is the underwriting department required to mark policies clearly indicating whether or not reinsurance applies?
3. Are there procedures existing to determine that all risks includible under treaty reinsurance contracts are identified and declared to the reinsurance company?
4. Are procedures in effect to provide for prompt follow-up and reimbursement of reinsurance claims:
   a. For reinsurance ceded by the company?
   b. For reinsurance assumed by the company?
5. Does the accounting system in use generate the information necessary for management's clear understanding of:
   a. The status of reinsurance contracts?
   b. The transactions which occurred during the year?
6. Are the companies reinsurance treaties written only with companies that qualify under the requirements of the regulatory insurance department? If not, identify those not so qualified.
7. Are the detailed accounting records maintained by other operating departments balanced to the accounting department records on a monthly basis?

Appendix E

Glossary of Terms

Accidental death benefit. A payment of a specified sum, in addition to the regular death benefit, in the event of the death of the insured by accident or by accidental means.

Actuary. An expert professionally trained in the evaluation of risk and the science of mathematical probabilities. Insofar as North America is concerned, membership in the American Academy of Actuaries or the Canadian Institute of Actuaries is evidence of professional qualification.

Ad interim policy reserve. A reserve calculated as of any date within a policy year.

Adjusted premium. An amount defined by the insurance laws of most states used in the computation of minimum legal cash surrender values.

Advance premiums. Premiums collected by the insurance company in advance of the premium due dates. A discount is allowed for certain advance payments.

Annual statement (convention statement, blank, or form). A statement on a prescribed form furnishing information regarding a company's financial condition as of December 31 and its operations for the year, filed by March 1 of the following year with Insurance Departments of the various states in which a company is authorized to transact business.

Annuity. A type of periodic payment of a fixed or variable amount arising out of a contract obligation.

Annuity, deferred. An annuity which will begin on a future date either at the expiration of a fixed number of years or at the attainment of a stated age.

Annuity, immediate. An annuity, purchased with a single payment, beginning currently.

Assessment companies. Companies selling to groups with similar interests such as church denominations or professional groups. Some assessment companies also sell directly to individual members of the general public. Such companies may or may not collect premiums. If funds are not sufficient to pay claims, assessments may be made against members.

Asset share. A realistic estimate of the amount accumulated by an insurance company for each dollar of insurance in force. An asset share study involves a projection of cash flow based on the best estimates of mortality, interest, withdrawals, dividends, and expenses, and their times of occurrence. Asset shares depict hypothetical financial results on a unit of business. Generally an asset share calculation is made for a unit policy on a particular plan and at a particular issue age representative of a particular class of policy. Asset shares calculation may be made prospectively or retrospectively. They are often made for projecting financial results into the future on the basis of assumed rates of mortality, interest, expense, and withdrawals, and for testing the effect of hypothetical changes in such rates. A company's entire business or a block of its business may be approximately represented by a grid of representative unit policies weighted according to the distribution of business. Asset shares for such a grid may be aggregated to show approximate financial results for the business so represented.

Assets, admitted. Assets stated at values at which they are permitted to be reported in the annual statement filed with the various Insurance Departments.

Assets, ledger. Assets which were traditionally recorded on a company's general ledger.

Assets, nonadmitted. Assets, or portions thereof, which are not permitted to be reported as admitted assets in the annual statement filed with the various Insurance Departments such as the excess of book value over statement value of investments, agents' balances, furniture, fixtures, supplies, and equipment other than certain data-processing equipment.

Assets, non-ledger. Assets which traditionally were not recorded on a company's general ledger such as the excess of statement value of stocks and bonds over book value, accrued interest, other accrued income on investments, and due and deferred premiums.

Association value. The value for Annual Statement purposes of certain invested assets. These values are set by the National Association of Insurance Commissioners and may differ from market value or amortized value.

Assumption. In life insurance, a set of rates (e.g., mortality or interest rates) on which calculations to determine premiums, reserves, etc., are based.

Automatic premium loan. A loan made under a provision in a life insurance policy that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the company if there is sufficient loan value.

Benefit. Any payment made under the terms of an insurance policy.

Block of business. In the broad sense, a group of policies as distinguished from a line of business. The term can be used in a narrow sense to refer to a particular group of policies issued under the same plan in a particular year.

Cash surrender value. The amount of cash which may be realized by the owner of a life insurance policy or annuity contract upon discontinuance and surrender of the policy or contract prior to its maturity.

Ceding company. The original or primary insurer who reinsures with another company called the reinsurer or assuming company.

Cession. Insurance passed on to the reinsurer by the primary or ceding company. Frequently, under certain types of reinsurance treaties, each transaction is given a number called a cession number.

Claim. A demand for payment of a policy benefit because of the occurrence of an insured event such as the death or disability of the insured or the maturity of an endowment or the incurrence of hospital or medical bills.

Coinsurance. The sharing of an insurance risk. In life insurance this arises most frequently in connection with reinsurance where the company which is the direct issuer of insurance passes some of it onto another company, the reinsurer, in order to avoid a disproportionately large risk on one insured. The reinsurer receives a proportionate part of the premiums less commissions and is liable for a corresponding part of all payments (dividends, cash values, death claims) made by the direct issuing company. Less frequently, "coinsurance" refers to an arrangement whereby the insured, himself, stands part of a loss.

Contract premium. The premium specified by the insurance contract; also referred to as the gross premium.

Contribution method. A method of computing dividends under which contributions made by any class of policies to the company's earnings is determined by comparing actual experience with assumptions made for mortality, interest, withdrawals, and expense in setting premium rates. Mutual life insurance companies are required to distribute divisible surplus to policyholders equitably. This is understood to mean distribution of divisible surplus to the various classes of policies in accordance with the contributions of such policies to such divisible surplus. In its classic form the contribution method determines dividends according to the three main sources of surplus earnings reflecting the experience with respect to mortality, interest, and expenses.

Convention statement, blank, or form. See Annual Statement.

Credit life insurance. Insurance issued on the lives of borrowers to cover payment of loan balances in case of death.

Decreasing term insurance. A type of term insurance the face value of which decreases over a period of years.

Deferred first year commission. A commission payable on monthly, quarterly, or semiannual premiums for the first policy year except the initial premium.

Deferred premiums. The semiannual, quarterly, or monthly net valuation premium needed to complete premium payments for the current policy year but not yet due. In computing statutory policy reserves for individual life insurance, deferred premiums are assumed to be paid in full.

Disability. Incapacity because of accident or sickness. In connection with life insurance, special benefits are sometimes provided in the event the insured is totally and permanently disabled.

Disability benefit feature. A feature included in some life insurance policies or annuity contracts providing for waiver of premiums or payment of a monthly income in the event the insured has become totally and/or permanently disabled.

Dividend class or classification. A group of policies which the company decides to consider as comprising a homogeneous unit for dividend purposes because of similarities in essential characteristics (premium rate, reserve, nonforfeiture bases, etc.). Sometimes more narrowly taken to mean a group of policies for which dividends per $1,000 of insurance are identical because all essential characteristics (policy series, plan, age, year of issue, etc.) are identical.

Dividend deposit. The accumulated amount, including interest, of all dividends which have been left by a policyholder as interest-bearing deposits.

Dividend fund method. A method used by some mutual life insurance companies in the development of the company's premium-dividend-policy value structure.

Dividend option. The privilege allowed a policyholder of choosing among certain methods of using his dividends. The dividends may be, for example: (1) paid in cash, (2) applied toward the payment of premiums, (3) left on deposit at interest, (4) used to purchase paid-up additional insurance, or (5) used to purchase one-year term insurance.

Dividends (to policyholders). Amounts distributed or credited to policyowners of participating policies. Under the various insurance laws, dividends must be apportioned to policyholders on an equitable basis. The dividend allotted to any policy should be based on the amount which the policy, as one of a class of similar policies, has contributed to the earnings available for distribution as dividends.

Endorsements or riders. Agreements not contained in the standard printed policy form, but printed, stamped, or written on or attached to it. When they are made a part of the contract, they alter, amend, extend, or restrict the provisions of the standard form.

Excess interest. The excess of interest credited by an insurance company over the amount guaranteed.

Experience premium method. A method for determining dividends to policyholders. Under this method the dividend is determined as the excess of the premium charged over a premium reflecting current levels of claim experience, interest, and expenses with appropriate provision for contingencies. This method is most commonly used for dividends earned under supplementary benefits such as Accidental Death or Waiver of Premium Disability Benefits. A variation of the method has sometimes been used for dividends on life insurance policies. In this modified form a conservative interest assumption is used in determining the experience premium, and an excess interest factor is added to the dividend as otherwise determined from the excess of the premium charged on the modified experience premium.

Expiry. Termination of insurance when the end of the period of term insurance is reached.

Extended term insurance. Insurance acquired under a nonforfeiture option in a policy providing for the use of cash surrender value to acquire term insurance for the face amount of the policy, the length of the term depending on the age at lapse and the cash surrender value.

First-year commission. Any commission payable on first-year premiums.

First-year premiums. Any premiums due during the first year the policy is in effect.

Fraternal companies. Companies having no stockholders, but which restrict their policyholders to a group with a common interest, such as a church group. They operate on a nonprofit basis for the benefit of policyholders and their beneficiaries.

Full preliminary term reserve method. A modified reserve method under which no reserve is established at the end of the first policy year.

Fund method. A method of computing dividends based upon asset share calculations.

Gains or losses from interest. The difference between net investment income and interest required to maintain reserves. A change in the interest basis on which reserves are determined automatically results in a change in the indicated gain or loss from interest.

Gains or losses from lapse or surrender. Differences between reserves held on surrendered or lapsed policies and cash values paid or reserves required on other forms of insurance taken by the insured in lieu of payment of cash value.

Gains or losses from loadings. Differences between expense loading contained in the premiums of the period and expenses for the period.

Gains or losses from mortality:

Annuities and supplementary contracts involving life contingencies. Differences between expected reserves released by death and actual reserves released by death during the period.

Ordinary life. Differences between expected death benefits on the company's reserve basis and death benefits incurred for the period, net of reserves released by death.

Grace period. The period, usually one month (31 days), following the due date of a premium during which the premium may be paid without penalty or other additional requirements. The policy remains in full force during this time. The grace period is required by law.

Gross premium. The premium specified by the insurance contract. The term is used in contrast to "net premium."

Gross premium reserve. A reserve determined by subtracting the present value of future gross premiums from the present value of future expenses and benefits.

Group insurance. Insurance issued, usually without medical examination, to a group of persons with related interests. It is usually issued to an employer covering his employees. A master policy is issued to the employer, or other representative of the group, and individual members of the group receive certificates as evidence of their insurance.

Guaranteed renewable policy. A health insurance policy which the insured has the right to continue in force by the timely payment of premiums which coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60), with the right reserved to the insurer to make changes in premium rates by classes. Also see Noncancellable policy.

Income disability benefit. The income disability benefit of a life insurance policy commonly requires that the insured be totally and permanently disabled, but the requirement of permanence is not ordinarily made for an income disability benefit contained in a health insurance policy, and some health insurance policies provide reduced benefit during partial disability.

Incontestable clause. A provision in a life or noncancellable accident and health insurance policy that the insurance company cannot contest the policy, except for nonpayment of premiums, after the policy has been in force for a stated period (usually one or two years) from date of issue.

Industrial insurance. Insurance written in relatively small amounts covering life, total and permanent disability, and accidental death benefits, the premiums on which are usually collected on a weekly or monthly basis by an agent of the company.

Initial policy reserve. The reserve on a policy at the beginning of the policy year. It is equal to the amount of the reserve at the close of the preceding policy year (the terminal reserve) plus the net premium for the current policy year.

Installment premium. A premium paid in installments throughout a policy year, rather than annually. Semiannual, quarterly, monthly, and sometimes weekly premiums are considered as installment premiums. (The basic premium in life insurance is an annual premium.)

Insured. The person on whose life an insurance policy is issued.

Investment expenses. Expenses which are properly chargeable against investment income.

Issue age. The age of the policyholder on the effective date of the policy. This is frequently the "age nearest birthday" on the effective date.

Lapse. The termination of a policy in its original status by failure to pay a premium due. If the policy has no cash value, the policy becomes forfeited, is terminated, and is out of force. If the policy has a cash value, the protection may be continued in modified form.

Lapse rate. The rate at which insurance policies terminate through failure of the insureds to continue making premium payments. The lapse rate may also be considered a rate of "non-persistence." It is usually expressed as a ratio of the number of policies on which the insureds failed to make premium payments during a given period to the total number of policies at the beginning of the period from which those lapses occurred.

Lapsed policy. A policy terminated from the premium paying in force because of nonpayment of premiums. Sometimes, for accounting purposes, the term is limited to a termination occurring before the policy has a cash or other value.

Legal reserve life insurance. Life insurance provided by an insurance company operating under insurance laws specifying the minimum basis for the reserves the company must maintain for its policies.

Level premium insurance. Insurance for which the premium is distributed evenly over the period during which premiums are payable.

Liabilities, ledger. Liabilities traditionally recorded on the company general ledger.

Liabilities, non-ledger. Liabilities traditionally recorded not on the company general ledger, but on other basic records.

Life expectancy. The average number of years of life remaining for persons of a particular age according to a particular mortality table.

Loading. An amount obtained by subtracting the net premium from the gross premium.

Mandatory securities valuation reserve. A reserve computed according to a formula specified by law or regulations to provide for possible losses on securities.

Maturity. The time when payment under a life insurance or endowment policy becomes due. A life insurance policy matures upon the death of the insured. An endowment policy matures upon the death of the insured or at the end of a specified period of time, whichever occurs first.

Mean reserve. A policy reserve computed as of the middle of a policy year on the assumption that the full net annual premium for that year has been paid. The mean reserve for any policy year is equal to the mean (or average) of the initial reserve at the beginning of that year and the terminal reserve at the end of that year.

Mode. The frequency of premium payment. The mode may be weekly, monthly, quarterly, semiannual, or annual.

Modified preliminary term reserve method. A method of computing a policy reserve under which a lesser portion of the first year's premium paid by the insured is added to the reserve than of premiums of subsequent years. There are various methods for arriving at the difference. The Illinois Standard Method and the Commissioners' Reserve Valuation Method are both modified preliminary term valuation methods.

Modified reserve method. Any of various reserve methods whereby a company establishes smaller reserves in the first policy year than under the net level reserve method.

Morbidity. The state of being diseased, mentally or physically, or being physically impaired.

Morbidity table. A statistical table showing the incidence, by age, of eligibility for a given sickness or accident benefit, based on the assumed morbidity which is being defined by the table. It is an instrument for measuring the probabilities associated with the given benefit and is one factor in computing premiums and reserves for policies providing such benefit.

Mortality cost. The assumed mortality cost (cost of insurance) for any year is the contribution necessary from each policy to meet the net death benefits anticipated during that year. It may be calculated by multiplying the net amount at risk at the beginning of the policy year by the death rate (shown in the mortality table employed in the computations) at the age attained by the insured at the beginning of the policy year.

Mortality ratio. The ratio of actual death benefits of the period to expected death benefits.

Mortality table. A statistical table showing the proportion of persons expected to die at each age, based on the assumed mortality which is being defined by the table, usually stated as so many deaths per thousand. It is the instrument for measuring probabilities of life and death. It is used as one factor in determining the amount of premium required at each age at issue of a policy.

Mortgage servicing agent. An agent servicing mortgage loans for the mortgagee at a prescribed rate under a contractual agreement.

Mutual life insurance companies. Companies which operate for the benefit of their policyholders and their beneficiaries and have no stockholders. Earnings are distributed to holders of participating policies. Some mutual life insurance companies issue non-participating policies.

Net amount at risk. The face amount of the policy less the terminal reserve for the policy year.

Net level reserve. A policy reserve computed by a method under which the increase in reserve on account of the first policy year is not reduced to accommodate acquisition expenses. For comparison, see Preliminary term reserve.

Net premium (valuation premium). As used in regulatory practices, that portion of the premium used in determining the valuation reserve and computed on the basis of prescribed mortality and interest rates. As used under generally accepted accounting principles, the portion of the gross premium required to provide for all benefits and expenses.

Noncancellable policy. A health insurance policy which the insured has the right to continue in force by the timely payment of premiums for a period which coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60) during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force. Also see Guaranteed renewable policy.

Nonforfeiture value. The value, if any, either in cash or in another form of insurance, available upon failure to continue the required premium payments. The other forms of insurance available are extended term insurance and reduced paid-up insurance.

Non-ledger assets. See Assets, non-ledger.

Non-ledger liabilities. See Liabilities, non-ledger.

Nonparticipating insurance. Insurance on which no dividends are payable. Usually issued by a stock life insurance company (as distinguished from a mutual company) at premium rates which are lower than those charged where dividends are payable.

Nonparticipating policy. A policy which is not entitled to dividends.

Ordinary life insurance. Life insurance usually issued in amounts of $1,000 or more with premiums payable on an annual, semiannual, quarterly, or monthly basis, as distinguished from industrial insurance. The term is also used to mean a plan of insurance for the whole of life with premiums payable for life.

Paid-up insurance. Insurance, including nonforfeiture paid-up insurance and paid-up additions purchased by dividends, on which all premiums have been paid and which is payable at the death of the insured or at the maturity date. It may be participating (sharing in dividend distribution).

Participating insurance. Insurance in which the policyholder is entitled to share in the company's earnings through dividends which reflect the difference between the premium charged and the actual experience.

Participating policy. A policy which is entitled to share in the dividend distribution.

Policy. The printed document issued to the insured by the company stating the terms of the insurance contract.

Policy anniversary date. The yearly recurrence of the "policy date." The policy date is a date specified in the policy as the date from which premium-payment dates are calculated and the date from which "policy years" for nonforfeiture option purposes are measured. The "date of issue" is the date of execution and is the date from which incontestable and suicide clause time limits are measured. The policy date frequently differs from the date of issue as for example, where the policy is dated back to the same age.

Policy loan. A loan made by a life insurance company to a policyholder on the security of the cash surrender value of his policy.

Policy or membership fee. Under the monthly premium plans for some accident and health insurance, the initial consideration is larger than the subsequent monthly premiums. The extra initial consideration is ordinarily termed a "policy fee" but is sometimes designated a "membership fee." It is common practice to permit the agent to retain the entire amount of this fee as compensation for securing the business. This term is also used sometimes in connection with life insurance to designate a portion of the gross premium which is the same, whether the policy is for a large amount or a small amount, so that the total premium per thousand is less in large policies than in small policies.

Policy reserve. The policy reserve may be regarded as the excess of the present value of the future benefits provided in the contract over the present value of the future net premiums payable under the policy. The policy reserve may also be regarded as the excess of the accumulated value of the net premiums already collected over the accumulated value of the benefits already paid.

Policy reserve strengthening. The voluntary transfer of amounts from surplus to policy reserves in order to provide for future policy benefits on more conservative assumptions. Such a transfer may be due to the employment of a lower interest assumption or of a different experience table with the assumption of the same or a lower rate of interest in the valuation of the respective benefit contracts than was employed in the respective valuation at the previous year end.

Preferred risk. An insured on whom the company expects to experience a better-than-average mortality.

Preliminary term reserve. A policy reserve in which a lesser portion of the first year's premium paid by the insured is added to the reserve than of premiums of subsequent years. There are various methods for arriving at the difference.

Reduced paid-up insurance. A form of insurance available as a nonforfeiture option. It provides for continuation of the original insurance plan, but for a reduced face amount with no further payment of premiums.

Reinstatement. A restoration of a lapsed policy to an active status. All policies contain a provision stating the conditions under which reinstatement will be allowed.

Reinsurance. A process by which the reinsurer (the first party) in consideration of a premium agrees to indemnify the reinsured (the second party) against a risk insured by the reinsured under a policy in favor of the insured (a third party). The reinsured may be referred to as the original or primary insurer or the ceding company.

Reinsurance assumed premiums. All premiums (less return premiums) arising from assuming the liability, in whole or in part, of another insurance company which is already covering the risk with a policy.

Reinsurance ceded premiums. All premiums arising from policies or coverage purchased from another insurance company for the purpose of transferring the liability, in whole or in part, assumed from direct or reinsurance assumed policies.

Renewable term insurance. Term insurance providing the right to renew at the end of the term for another term or terms without providing evidence of insurability. The premium rates increase at each renewal.

Renewal premium. Any premium payable for an insurance policy after the first year.

Reserve basis. The particular set of assumptions as to interest and mortality or morbidity on which reserves are calculated.

Retention. The amount of insurance risk which a company carries for its own account. Any insurance issued in excess of the retention is reinsured. In group insurance this term is also used to define the percentage of premium collected which the company will retain for expense and contingencies.

Retention limit. The maximum amount of insurance which a company will assume on one life at its own risk.

Separate accounts. Separate accounts constitute a separate operation under which the assets fund the liabilities to variable annuity contractholders, pension funds, and others.

Service fee. A fee paid to servicing agents (usually about one-half of one percent per annum) for collecting mortgage loan payments, remitting them, inspecting the security, and checking on tax and insurance matters affecting the property. Service fee is also often used to indicate nonvested renewal commissions paid to the servicing life insurance agent after the expiration of normal renewal commissions on a policy.

Settlement option. A choice of an alternative method of payment of the proceeds of an insurance or annuity policy, by the insured or his beneficiary, in lieu of the basic method of payment provided in the policy. Usually a settlement option envisages annuity or installment payments even if the basic method of payment provides for a lump-sum settlement.

Single premium. A lump-sum consideration received by an insurance company in accordance with an insurance or annuity contract.

Statutory. Relating to the laws of the federal or state government. Also loosely used to include governmental regulations.

Statutory reserve. A policy reserve equal to, or greater than, the minimum computed under the method prescribed by state regulation, which method specifies the mortality or morbidity table to be used, the rate of interest to be assumed, and the formula to be applied.

Stock life insurance companies. Companies which operate for the purpose of obtaining profit for their stockholders. In general, stock life insurance companies issue nonparticipating policies, but some also issue participating policies.

Substandard insurance. Insurance issued on lives involving extra hazards due to physical condition, occupation, habits, or family history. An extra premium is charged for the extra risk, thus making the total premium higher than that on standard insurance.

Suicide clause. A provision in a life insurance policy that the risk of death by suicide (sane or insane) is excluded during the first one or two years after the date of issue. In event of suicide within this period, there is a refund of premiums paid.

Supplementary contract. A contract issued by the company to a beneficiary in exchange for the matured policy when a life insurance policy is settled under one of the settlement options.

Supplementary contract without life contingencies. A supplementary contract providing for leaving a specified sum with the company at interest at a specified rate, subject to withdrawal under stated conditions of all or any part of the interest or of the original sum with interest or for payment by the company of a specified number of installments of a specified amount. Interest is taken into consideration in computing the amount of each installment. No life contingencies are involved.

Supplementary contract with life contingencies. A supplementary contract issued in the form of a life annuity contract on one or more lives or a combination of an annuity certain for a specified period and a deferred life annuity of any type.

Surrender. To accept some form of nonforfeiture option. Usually the policy is physically surrendered to the insurance company either for cash or in exchange for an extended or paid-up policy.

Tabular cost. As used in the Annual Statement, the aggregate expected mortality and disability cost for life insurance policies.

Tabular interest. Generally known as the interest required to maintain the reserve. The amount of interest which it had been assumed would be earned during the year on the policy and claim reserves and the valuation premiums on all benefit contracts which were in force at any time during the year.

Tabular net premium. As used in the Annual Statement this term refers to the premium which is used in determining the policy reserve. It is frequently referred to as the net premium or the valuation (or actuarial) premium.

Terminal policy reserve. The policy reserve at the end of the policy year. It is equal to the amount of the reserve at the beginning of the policy year (the initial reserve) plus interest on the reserve for one year and less the cost of insurance for the respective policy year.

Term insurance. Insurance providing for a death benefit only if the insured dies within the period of time specified in the contract. Coverage is for level or reducing amounts for stated periods such as 1, 5, 10 years or to a stated age. It provides life insurance protection for a temporary period of time and, therefore, is the least expensive. There are generally no loan or cash values. A term policy may be convertible, that is, it may grant the privilege of exchange without medical examination, for permanent insurance on the whole life or endowment plan. It may also be renewable at the option of the insured without furnishing evidence of insurability (automatically renewable).

Total and permanent disability. Total disability which is presumed to be permanent in character. Frequently total disability is presumed to be permanent (for the purpose of beginning benefits) if it has persisted, and been total, for some specified period of time, such as three or six months.

Uncollected premiums. Premiums payable, but not yet paid, on policies still carried on the company's books as being in force.

Underwriter. (1) An individual or company who insures risks, (2) an agent who solicits insurance, or (3) an employee who determines whether applicants are suitable risks for insurance.

Valuation premium. See Net premium.

Variable annuity. An annuity which includes a provision for benefit payments to vary according to the investment experience of the separate account in which the amounts paid to provide for this annuity are allocated.

Waiver of premium. A waiver of premium benefit is also typically included in noncancellable or guaranteed renewable disability income policies. In such policies it is not required that disability be permanent.

Appendix F

Statement of Position

CONFIRMATION OF INSURANCE POLICIES IN FORCE

August 4, 1978

Issued by the Auditing Standards Division
American Institute of Certified Public Accountants

Confirmation of Insurance Policies in Force

1. In February 1975, the AICPA Special Committee on Equity Funding stated "... except for certain observations relating to confirmation of insurance in force and auditing related party transactions, generally accepted auditing standards are adequate and ... no changes are called for in the procedures commonly used by auditors." The AICPA industry audit guide, *Audits of Stock Life Insurance Companies* (paragraph 3.78), states: "It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc." The special committee recommended "that the Institute's auditing standards executive committee consider whether the Life Insurance Audit Guide requires clarification with regard to the confirmation of policies with policyholders."

2. The special committee further stated:

> Another auditing procedure, which heretofore has not been considered particularly useful, is verification of the authenticity of a selected number of policies included in the in-force inventory by direct confirmation with the policyholders. Such a procedure has not generally been considered necessary because it would be unusual for companies to overstate liabilities. Inflation of the inventory of life insurance in force by a company that follows statutory accounting would result in an overstatement of the liability for future policyholder benefits and a reduction in current earnings. However, when companies report on the basis of generally accepted accounting principles (GAAP) there could be motivation for overstating insurance in force because it could result in an addition to current earnings.
>
> There could be an additional motivation for overstating insurance in force when reinsurance of policies has the effect of materially increasing current earnings, which can occur when a company reports on the basis of either GAAP or statutory accounting. Reinsurance of life insurance policies permits the elimination of the related liability for future policyholder benefits. Under certain circumstances, reinsurance may also result in increasing current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of the reinsured policies.

3. As stated above, the audit guide suggests confirmation of insurance policies in force directly with policyholders; however, the audit guide does not discuss circumstances when confirmation would be appropriate and, as a result, practice has varied. The purpose of this statement of position is to identify those circumstances in which the independent auditor ordinarily should confirm insurance policies in force. This statement of position is applicable to both stock and mutual life insurance companies.

4. Satisfactory results of the comparison of insurance policies in force with premium collections along with other ordinary auditing procedures (see paragraphs 3.70 through 3.90, 6.08 through 6.14, and 9.02 through 9.07 of the audit guide) will normally provide the auditor with sufficient competent evidential matter as to the validity of those policies included in the inventory of insurance policies in force. However, the auditor ordinarily should confirm insurance policies in force with policyholders in the following circumstances:

a. Proper maintenance of the inventory of insurance in force may be materially deficient due to an absence of segregation of duties or other controls.

b. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.

c. Additions to insurance in force cannot be related to the collection of premiums.

d. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not audited by the auditor.

e. The company markets insurance products, such as those with immediate cash value features or with unusual commissions arrangements, that could motivate the agent to submit fictitious policies.

f. Ceded reinsurance activities can materially increase earnings or investable funds.

Effective Date

5. This statement of position provides for practices that may differ in certain respects from present acceptable practices. Accordingly, this statement of position will be effective for audits made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1978.

Appendix G

Paragraph Cross-Reference Table for Statement of Financial Accounting Standards No. 60, Accounting and Reporting by Insurance Enterprises

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* extracts the specialized accounting principles and practices described in the AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies,* Statement of Position 79-3, *Accounting for Investments of Stock Life Insurance Companies,* and other AICPA guides and statements of position relating to insurance enterprises. Although the statement extracts existing specialized principles and practices of insurance enterprises, it has not carried forward most of the background material and discussion of alternatives from the guide.

For the convenience of readers, the following table provides cross-references between paragraphs of the FASB statement and the related discussions in the guide. Readers should be aware that statements of the FASB are enforceable under rule 203 of the AICPA Code of Professional Conduct.

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*		AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies*
Paragraph		*Paragraph*
4	Introduction	8.12-8.15
6	Applicability and Scope	Preface
7-8	General Principles	8.01-8.27, 8.73-8.83
13-14	Premium Revenue Recognition	
	Short-duration contracts	8.15-8.19, 8.21-8.24, 8.64-8.87
15	Long-duration contracts	8.01-8.24
17	Claim Cost Recognition	6.20-.24, 8.64-8.65, 8.73-8.82
20	Claim Adjustment Expenses	8.27-8.41
21	Liability for Future Policy Benefits	6.01-.08, 6.15-6.19, 8.15-8.16, 8.21-8.37
22	Investment Yields	8.41-8.45, 8.83
23	Mortality	8.46-8.47
24	Morbidity	8.81
25	Terminations	8.48-8.52, 8.82
26	Expenses	8.24-8.45
27	Costs Other Than Those Relating to Claims and Policy Benefits	8.38-8.45
28-31	Acquisition Costs	8.27-8.37, 8.64-8.65, 8.74-8.81
32, 35-37	Premium Deficiencies	8.64-8.65, 8.89-8.93
38-40[††]	Reinsurance	3.27-3.32, 8.108-8.111

[††] FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60. The provisions of paragraphs 39 and 40 of Statement No. 60 are incorporated in paragraph 18 of Statement No. 113.

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* Paragraph		AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies* Paragraph
41-43	Policyholder Dividends	8.53-8.62
44	Retrospective and Contingent Commission Arrangements	8.84
45-52 *	Investments	See note **
53-54	Separate Accounts	5.12-5.14
55-59 †	Income Taxes of Life Insurance Enterprises	8.94-8.95, APP C
	Disclosures	
60b	Estimation of liability for future policy benefits	10.05-10.06
60c	Acquisition costs	10.03-10.04
60f††	Reinsurance transactions	10.18
60g	Participating insurance	10.07-10.08
60h	Stockholders' equity and statutory capital and surplus	8.113-8.114, 10.09-10.16
60i-j †	Income taxes	10.17

* Paragraph 49 of FASB Statement No. 60 has been superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases.*

** The accounting principles and practices in the FASB statement regarding investments are extracted from Statement of Position 79-3, *Accounting for Investments of Stock Life Insurance Companies.* That statement of position superseded the section on "Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon," in paragraphs 8.96-8.100 of this guide.

† Paragraphs 55 through 58, 60(i), and 60(j) have been superseded by FASB Statement No. 96, *Accounting for Income Taxes.*

†† FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60. The provisions of paragraphs 39 and 40 of Statement No. 60 are incorporated in paragraph 18 of Statement No. 113.

Appendix H

Statement of Financial Accounting Standards No. 60

Accounting and Reporting by Insurance Enterprises

June 1982

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Statement of Financial Accounting Standards No. 60
Accounting and Reporting by Insurance Enterprises
June 1982

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

   a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

   b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected **claim**[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

5. Title insurance contracts provide protection for an extended period and therefore are considered long-duration contracts. Premiums from title insurance contracts ordinarily are recognized as revenue on the effective date of the contract because most of the services associated with the contract have been rendered by that time. Estimated claim costs are recognized when premium revenue is recognized because the insurance provides protection against claims

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[1] Terms defined in the glossary (Appendix A) are in **boldface type** the first time they appear in this Statement.

caused by problems with title to real estate arising out of ascertainable insured events that generally exist at that time.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock **life insurance enterprises, property and liability insurance enterprises,**[2] and **title insurance enterprises.** Except for the sections on premium revenue and claim cost recognition and **acquisition costs** (paragraphs 9-11, 13-18, and 20-31), this Statement applies to **mortgage guaranty insurance enterprises.** It does not apply to mutual life insurance enterprises, **assessment enterprises,** or **fraternal benefit societies.** [See FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* for amendments to this paragraph.]

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force[3] for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

a. *Short-duration contract.* The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. *Long-duration contract.* The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain **term life insurance** contracts, such as **credit life insurance.** Examples of long-duration contracts include **whole-life contracts,** guaranteed renewable term life contracts, **endowment contracts, annuity contracts,** and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and **group insurance** contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A **liability for unpaid claims** (including estimates of costs for claims relating to insured events that have occurred but

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[2] Property and liability insurance enterprises, for purposes of this Statement, include stock enterprises, mutual enterprises, and **reciprocal or interinsurance exchanges.**

[3] *In force* refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

have not been reported to the insurer) and a **liability for claim adjustment expenses** shall be accrued when insured events occur.

10. Premiums from long-duration contracts shall be recognized as revenue when due from policyholders. A liability for expected costs relating to most types of long-duration contracts shall be accrued over the current and expected renewal periods of the contracts. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future **net premiums** to be collected from policyholders (**liability for future policy benefits**) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, **mortality, morbidity, terminations,** and expenses, applicable at the time the insurance contracts are made. In addition, liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur.

11. Costs that vary with and are primarily related to the acquisition of insurance contracts (acquisition costs) shall be capitalized and charged to expense in proportion to premium revenue recognized. Other costs incurred during the period, such as those relating to investments, general administration, and policy **maintenance,** shall be charged to expense as incurred.

12. Accounting for investments by insurance enterprises presumes that (a) insurance enterprises have both the ability and the intent to hold long-term investments, such as bonds, mortgage loans, and redeemable preferred stocks, to maturity and (b) there is no decline in the market value of the investments other than a temporary decline. Accordingly, bonds, mortgage loans, and redeemable preferred stocks shall be reported at amortized cost. Common and nonredeemable preferred stocks shall be reported at market, and real estate shall be reported at depreciated cost.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

14. If premiums are subject to adjustment (for example, retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the **cost recovery method** or the **deposit method** may be used until the ultimate premium becomes reasonably estimable.

Long-Duration Contracts

15. Premiums from long-duration contracts, such as whole-life contracts (including limited-payment and single-premium life contracts), guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders. [This paragraph is superseded by FASB Statement No. 97.]

16. Premiums from title insurance contracts shall be considered due from policyholders and, accordingly, recognized as revenue on the effective date of the insurance contract. However, the binder date (the date a commitment to issue a policy is given) is appropriate if the insurance enterprise is legally or contractually entitled to the premium on the binder date. If reasonably estimable, premium revenue and costs relating to title insurance contracts issued by agents shall be recognized when the agents are legally or contractually entitled to the premiums, using estimates based on past experience and other sources. If not reasonably estimable, premium revenue and costs shall be recognized when agents report the issuance of title insurance contracts.

Claim Cost Recognition

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to **incurred but not reported claims,** shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.[4] Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as **salvage, subrogation,** or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

19. Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved. Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.

20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (**claim adjustment expenses**) shall be accrued

[4] Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60(d)).

when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.[5]

Liability for Future Policy Benefits

21. A liability for future policy benefits relating to long-duration contracts other than title insurance contracts (paragraph 17) shall be accrued when premium revenue is recognized. The liability, which represents the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of **gross premium** required to provide for all benefits and expenses), shall be estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges. The assumptions shall include provision for the **risk of adverse deviation.** Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the "lock-in concept") unless a premium deficiency exists (paragraphs 35-37). Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

Investment Yields

22. Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are made. The interest assumption for each block of new insurance contracts (a group of insurance contracts that may be limited to contracts issued under the same plan in a particular year) shall be consistent with circumstances, such as actual yields, trends in yields, portfolio mix and maturities, and the enterprise's general investment experience.

Mortality

23. Mortality assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected mortality.

Morbidity

24. Morbidity assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected incidences of disability and claim costs. Expected incidences of disability and claim costs for various types of insurance (for example, noncancelable and guaranteed renewable accident and health insurance contracts) and other factors, such as occupational class, waiting period, sex, age, and benefit period, shall be considered in making morbidity assumptions. The risk of antiselection (the tendency for lower terminations of poor risks) also shall be considered in making morbidity assumptions.

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[5] Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.

Terminations

25. Termination assumptions used in estimating the liability for future policy benefits shall be based on anticipated terminations and **nonforfeiture benefits,** using anticipated **termination rates** and contractual nonforfeiture benefits. Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. If composite rates are used, the rates shall be representative of the enterprise's actual mix of business. Termination assumptions shall be made for long-duration insurance contracts without termination benefits because of the effects of terminations on anticipated premiums and claim costs.

Expenses

26. Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses.

Costs Other Than Those Relating to Claims and Policy Benefits

27. Costs incurred during the period, such as those relating to investments, general administration, and policy maintenance, that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts shall be charged to expense as incurred.

Acquisition Costs

28. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.

29. Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as an asset.

30. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, shall be applied to applicable unearned premiums throughout the period of the contracts.

31. Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquir-

ing, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Short-Duration Contracts

33. A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected **dividends to policyholders,** unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.[6]

34. A premium deficiency shall first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

Long-Duration Contracts

35. Original policy benefit assumptions for long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued (paragraph 21). However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs. In those circumstances, a premium deficiency shall be determined as follows:

Present value of future payments for benefits and related settlement and maintenance costs, determined using revised assumptions based on actual and anticipated experience	$XX
Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience	XX
Liability for future policy benefits using revised assumptions	XX
Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	XX
Premium deficiency	$XX

36. A premium deficiency shall be recognized by a charge to income and (a) a reduction of unamortized acquisition costs or (b) an increase in the liability for future policy benefits. If a premium deficiency does occur, future changes in the liability shall be based on the revised assumptions. No loss shall be reported currently if it results in creating future income. The liability for future policy benefits using revised assumptions based on actual and anticipated experience shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date.

37. A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate,

[6] Disclosure is required regarding whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists (paragraph 60(e)).

but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognized in later years.

Reinsurance

38. Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. **Reinsurance** premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement. [This paragraph is superseded by FASB Statement No. 113.]

39. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized (paragraph 29). If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost. [This paragraph is superseded by FASB Statement No. 113.]

40. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer. [This paragraph is superseded by FASB Statement No. 113.]

Policyholder Dividends

41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

42. If limitations exist on the amount of net income from **participating insurance** contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in deter-

mining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

Retrospective and Contingent Commission Arrangements

44. If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

Investments

45. Bonds shall be reported at amortized cost if the insurance enterprise has both the ability and the intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. If an insurance enterprise is a trader in bonds and does not intend to hold the bonds until maturity, bonds shall be reported at market and temporary changes in the market value of the bonds shall be recognized as unrealized gains or losses (paragraph 50).

46. Common and nonredeemable preferred stocks shall be reported at market and temporary changes in the market value of those securities shall be recognized as unrealized gains or losses (paragraph 50). Preferred stocks that by their provisions must be redeemed by the issuer shall be reported at amortized cost if the insurance enterprise has both the ability and the intent to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

47. Mortgage loans shall be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans shall be included in realized gains and losses.

48. Real estate investments shall be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments shall be included in realized gains and losses.

49. Normal commitment fees received in connection with the placement of mortgage loans (less direct costs) shall be capitalized and recognized as revenue over the commitment period. Commitment fees that exceed current (normal) fees for mortgage loan commitments shall be considered an adjustment of the effective interest yield on the loan. Those excess fees shall be capitalized until the loan is made and then recognized as revenue over the period of the mortgage loan. If the mortgage loan is not ultimately made, the unamortized commitment fee shall be recognized as revenue at the end of the commitment period. [This paragraph is superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*]

50. Realized gains and losses on all investments (including, but not limited to, stocks, bonds, mortgage loans, real estate, and joint ventures) shall be reported

in the income statement below operating income and net of applicable income taxes. Realized gains and losses on the sale of assets other than investments, such as real estate used in the business, shall be reported in accordance with APB Opinion No. 30, *Reporting the Results of Operations.* Unrealized investment gains and losses, net of applicable income taxes, shall be reported as a separate component of stockholders' (policyholders') equity. Except as discussed in paragraph 51, unrealized gains or losses on common stocks, preferred stocks, or publicly traded bonds shall not be recognized in income until the sale, maturity, or other disposition of the investment.[7] [The first sentence of this paragraph is superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*]

51. If a decline in the value of a common stock, preferred stock, or publicly traded bond below its cost or amortized cost is considered to be other than temporary, the investment shall be reduced to its net realizable value, which becomes the new cost basis. The amount of the reduction shall be reported as a realized loss. A recovery from the new cost basis shall be recognized as a realized gain only at the sale, maturity, or other disposition of the investment.

Real Estate Used in the Business

52. Real estate shall be classified either as an investment or as real estate used in the enterprise's operations, depending on its predominant use. Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rental expense shall not be recognized for real estate used in the business.

Separate Accounts

53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or **variable annuity contracts,** pension plans, and similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.

54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

Income Taxes of Life Insurance Enterprises

Deferred Income Taxes

55. Because of the provisions of the Life Insurance Company Income Tax Act of 1959 (Act),[8] timing differences (paragraph 13(e) of APB Opinion No. 11,

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[7] This paragraph is not intended to preclude the accrual of losses on private-placement bonds when both conditions in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies,* are met.

[8] The Act contemplated taxation of total income of life insurance enterprises, but the determination of tax is complex because of the manner in which total taxable income is classified as investment income, gain from operations (including investment income and less special deductions for certain accident and health, group life, and nonparticipating insurance contracts), policyholders' surplus (gain from operations previously excluded from tax and the special deductions), and the interrelationship of those elements. Taxable income consists of (a) taxable investment income, (b) 50 percent of the amount by which gain from operations exceeds taxable

Accounting for Income Taxes) of life insurance enterprises arising in the current period may not affect the determination of income taxes in future periods when those timing differences reverse. Amounts determined in the with-and-without calculation (paragraph 36 of Opinion 11) need to be considered further to determine whether the difference will reverse in the future. Deferred taxes need not be provided for the current tax effect of timing differences if circumstances indicate that the current tax effect will not reverse in the future. Similarly, a change in category of taxation (the basis on which the enterprise determines its income tax liability) resulting from the with-and-without calculation need not be recognized unless circumstances indicate that a change in category will result when the timing difference reverses. If the reversal of tax effects cannot be reasonably determined, deferred income taxes shall be provided based on the differential determined using the with-and-without calculation as if the enterprise's tax return was filed on the basis on which financial statements are prepared, including any resulting change in category of taxation. [This paragraph is superseded by FASB Statement No. 96, *Accounting for Income Taxes*.]

56. Although (a) special deductions (allowable only for income tax purposes) never enter into the determination of pretax accounting income in any period and (b) the amount of policyholder dividend deductions and special deductions may be limited on the tax return (the unused deductions cannot be carried forward to subsequent periods), the amount of policyholder dividend deductions and available special deductions and limitations on those deductions may properly be determined based on pretax accounting income. For example, unused policyholder dividend deductions and special deductions may be used to offset timing differences that affect taxable income to the extent that the limitations on those deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from the reversal of timing differences will not be offset by like deductions. In the case of provisions for policyholder dividends (including policyholder dividends deducted as part of the change in the liability for future policy benefits), which may be timing differences themselves, statutory limitations shall not be applied to eliminate their current tax effect unless circumstances indicate that the dividends will be limited when the timing differences reverse. Special deductions that are directly affected by timing differences need to be redetermined in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when the timing differences reverse. If the reversal of tax effects cannot be reasonably determined, special deductions that are not affected by timing differences and, therefore, do not reverse shall be limited to amounts available in the tax return. [This paragraph is superseded by FASB Statement No. 96.]

57. A life insurance enterprise's liability for future policy benefits and capitalization and amortization of acquisition costs indirectly affect the amount of taxable investment income used in determining the income tax provision for financial reporting purposes. Differences in taxable investment income caused by differences between the liability for future policy benefits and capitaliza-

(Footnote Continued)

investment income, and (c) any reductions in policyholders' surplus. If gain from operations is less than taxable investment income, the lesser amount, plus any reductions in policyholders' surplus, is taxable income. If a loss from operations occurs, there is no taxable income except to the extent that there are reductions in policyholders' surplus. Deductions from gain from operations for policyholder dividends and the special deductions are limited and unused deductions cannot be carried forward to subsequent periods. [Footnote 8 superseded by FASB Statement No. 96, *Accounting for Income Taxes*.]

tion and amortization of acquisition costs for income tax and financial reporting purposes shall be considered permanent differences (paragraph 13(f) of Opinion 11). [This paragraph is superseded by FASB Statement No. 96.]

58. If deferred income taxes have not been provided on timing differences on the presumption that the timing differences will not have tax effects when they reverse and circumstances change so that it becomes apparent that tax effects will result, deferred income taxes attributable to those timing differences shall be accrued and reported as income tax expense in that period; those income taxes shall not be reported as an extraordinary item. If deferred income taxes have been provided on timing differences and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, income taxes previously deferred shall be included in income only as the related timing differences reverse, regardless of whether the life insurance enterprise uses the gross change or net change method (paragraph 37 of Opinion 11). [This paragraph is superseded by FASB Statement No. 96.]

Policyholders' Surplus

59. A difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a life insurance enterprise may not reverse until indefinite future periods or may never reverse. The insurance enterprise controls the events that create the tax consequences, and the enterprise generally is required to take specific action before the initial difference reverses. Therefore, a life insurance enterprise shall not accrue income taxes on the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus. However, if circumstances indicate that the insurance enterprise is likely to pay income taxes, either currently or in later years, because of a known or expected reduction in policyholders' surplus, income taxes attributable to that reduction shall be accrued as a tax expense of the current period; the accrual of those income taxes shall not be accounted for as an extraordinary item.

Disclosures

60. Insurance enterprises shall disclose the following in their financial statements:

a. The basis for estimating the liabilities for unpaid claims and claim adjustment expenses
b. The methods and assumptions used in estimating the liability for future policy benefits with disclosure of the average rate of assumed investment yields in effect for the current year encouraged
c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period
d. The carrying amount of liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts that are presented at present value in the financial statements and the range of interest rates used to discount those liabilities
e. Whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists
f. The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums

assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses. [This paragraph is superseded by FASB Statement No. 113.]

g. The relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders

h. The following information relating to stockholders' equity, statutory capital and surplus, and the effects of **statutory accounting practices** on the enterprise's ability to pay dividends to stockholders:
   (1) The amount of statutory capital and surplus
   (2) The amount of statutory capital and surplus necessary to satisfy regulatory requirements (based on the enterprise's current operations) if significant in relation to the enterprise's statutory capital and surplus
   (3) The nature of statutory restrictions on the payment of dividends and the amount of retained earnings that is not available for the payment of dividends to stockholders

i. For life insurance enterprises or a parent of a life insurance enterprise that is either consolidated or accounted for by the equity method:
   (1) The treatment of policyholders' surplus under the U.S. Internal Revenue Code and that income taxes may be payable if the enterprise takes certain specified actions, which shall be appropriately described
   (2) The accumulated amount of policyholders' surplus for which income taxes have not been accrued [This paragraph is superseded by FASB Statement No. 96.]

j. For life insurance enterprises, any retained earnings in excess of policyholders' surplus on which no current or deferred federal income tax provisions have been made and the reasons for not providing the deferred taxes. [This paragraph is superseded by FASB Statement No. 96.]

Amendments to Other Pronouncements

61. The following footnote is added to the end of paragraph 6 of Opinion 11:

> For life insurance enterprises, also refer to paragraphs 55-59 and subparagraphs 60(i) and 60(j) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*

62. The provisions of APB Opinion No. 23, *Accounting for Income Taxes—Special Areas,* that discuss policyholders' surplus of life insurance enterprises have been included in this Statement without reconsideration, and paragraphs 26-30 and footnote 11 of Opinion 23 are superseded by this Statement.

63. The references to AICPA insurance industry related Guides in footnote 8 of Opinion 30, paragraphs 41 and 102 of FASB Statement No. 5, *Accounting for Contingencies,* paragraph 4 of FASB Interpretation No. 15, *Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company,* and paragraph 7 of FASB Interpretation No. 22, *Applicability of Indefinite Reversal Criteria to Timing Differences,* are replaced by a reference to FASB

Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* The references to AICPA Statements of Position (SOPs) 78-6, *Accounting for Property and Liability Insurance Companies,* and 79-3, *Accounting for Investments of Stock Life Insurance Companies,* and to the AICPA Industry Audit Guides, *Audits of Fire and Casualty Insurance Companies and Audits of Stock Life Insurance Companies,* are deleted from Appendix A of FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.* The reference to the AICPA project on accounting by title insurance companies, which resulted in the issuance of SOP 80-1, *Accounting for Title Insurance Companies,* is deleted from Appendix B of Statement 32. [See FASB Statement No. 97 for amendments to this paragraph.]

Effective Date and Transition

64. This Statement shall be effective for fiscal years beginning after December 15, 1982, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year presented. The individual effects of changing to conform to the provisions of this Statement shall be disclosed in the financial statements.

65. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying this Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which this Statement is first applied. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes.*)

The provisions of this Statement need not be applied to immaterial items.

This Statement was approved by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan

David Mosso
Robert T. Sprouse
Ralph E. Walters

APPENDIX A

Glossary

66. This appendix defines certain terms that are used in this Statement.

Acquisition costs

Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Annuity contract

A contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life. Also refer to variable annuity contract.

Assessment enterprise

An insurance enterprise that sells insurance to groups with similar interests, such as church denominations or professional groups. Some assessment enterprises also sell insurance directly to the general public. If funds are not sufficient to pay claims, then assessments may be made against members.

Claim

A demand for payment of a policy benefit because of the occurrence of an insured event, such as the death or disability of the insured; the maturity of an endowment; the incurrence of hospital or medical bills; the destruction or damage of property and related deaths or injuries; defects in, liens on, or challenges to the title to real estate; or the occurrence of a surety loss.

Claim adjustment expenses

Expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any legal and adjusters' fees, and the costs of paying claims and all related expenses.

Cost recovery method

Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Credit life insurance

Life insurance, generally in the form of decreasing term insurance, that is issued on the lives of borrowers to cover payment of loan balances in case of death.

Deposit method

Under the deposit method, premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Dividends to policyholders

Amounts distributable to policyholders of participating insurance contracts as determined by the insurer. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. The dividend allotted to any contract often is based on the amount that the contract, as one of a class of similar contracts, has contributed to the income available for distribution as dividends.

Endowment contract

An insurance contract that provides insurance from inception of the contract to the maturity date (endowment period). The contract specifies that a stated amount, adjusted for items such as policy loans and dividends, if any, will be paid to the beneficiary if the insured dies before the maturity date. If the insured is still living at the maturity date, the policyholder will receive the maturity amount under the contract after adjustments, if any. Endowment contracts generally mature at a specified age of the insured or at the end of a specified period.

Fraternal benefit society

An organization that provides life or health insurance to its members and their beneficiaries. Policyholders normally participate in the earnings of the society, and insurance contracts stipulate that the society has the power to assess its members if the funds available for future policy benefits are not sufficient to provide for benefits and expenses.

Gross premium

The premium charged to a policyholder for an insurance contract. Also refer to net premium.

Group insurance

Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

Incurred but not reported claims

Claims relating to insured events that have occurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

Liability for claim adjustment expenses

The amount needed to provide for the estimated ultimate cost required to investigate and settle claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the insurer at that date.

Liability for future policy benefits

An accrued obligation to policyholders that relates to insured events, such as death or disability. The liability for future policy benefits can be viewed as either (a) the present value of future benefits to be paid to or on behalf of policyholders and expenses less the present value of future net premiums payable under the insurance contracts or (b) the accumulated amount of net premiums already collected less the accumulated amount of benefits and expenses already paid to or on behalf of policyholders.

Liability for unpaid claims

The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be required for future payments on both (a) claims that have been reported to the insurer and (b) claims relating to insured events that have occurred but have not been reported to the insurer as of the date the liability is estimated.

Life insurance enterprise

An enterprise that can issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life insurance enterprises may be either stock or mutual organizations.

Maintenance costs

Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Morbidity

The relative incidence of disability due to disease or physical impairment.

Mortality

The relative incidence of death in a given time or place.

Mortgage guaranty insurance enterprise

An insurance enterprise that issues insurance contracts that guarantee lenders, such as savings and loan associations, against nonpayment by mortgagors.

Net premium

As used in this Statement for long-duration insurance contracts, the portion of the gross premium required to provide for all benefits and expenses.

Nonforfeiture benefits

Those benefits in a life insurance contract that the policyholder does not forfeit, even for failure to pay premiums. Nonforfeiture benefits usually include cash value, paid-up insurance value, or extended-term insurance value.

Participating insurance

Insurance in which the policyholder is entitled to participate in the earnings or surplus of the insurance enterprise. The participation occurs through the distribution of dividends to policyholders.

Property and liability insurance enterprise

An enterprise that issues insurance contracts providing protection against (a) damage to, or loss of, property caused by various perils, such as fire and theft, or (b) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises also can issue accident and health insurance contracts. The term *property and liability insurance enterprise* is the current terminology used to describe a fire and casualty insurance enterprise. Property and liability insurance enterprises may be either stock or mutual organizations.

Reciprocal or interinsurance exchange

A group of persons, firms, or corporations commonly referred to as "subscribers" that exchange insurance contracts through an attorney-in-fact (an attorney authorized by a person to act in that person's behalf).

Reinsurance

A transaction in which a reinsurer (assuming enterprise), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding enterprise). However, the legal rights of the insured are not affected by the reinsurance transaction and the insurance enterprise issuing the insurance contract remains liable to the insured for payment of policy benefits.

Risk of adverse deviation

A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses. The concept is referred to as *risk load* when used by property and liability insurance enterprises.

Salvage

The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Statutory accounting practices

Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

Subrogation

The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

Term life insurance

Insurance that provides a benefit if the insured dies within the period specified in the contract. The insurance is for level or declining amounts for stated periods, such as 1, 5, or 10 years, or to a stated age. Term life insurance generally has no loan or cash value.

Termination

In general, the failure to renew an insurance contract. Involuntary terminations include death, expirations, and maturities of contracts. Voluntary terminations of life insurance contracts include lapses with or without cash surrender value and contract modifications that reduce paid-up whole-life benefits or term-life benefits.

Termination rate

The rate at which insurance contracts fail to renew. Termination rates usually are expressed as a ratio of the number of contracts on which insureds failed to pay premiums during a given period to the total number of contracts at the beginning of the period from which those terminations occurred. The complement of the termination rate is persistency, which is the renewal quality of insurance contracts, that is, the number of insureds that keep their insurance in force during a period. Persistency varies by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors.

Title insurance enterprise

An enterprise that issues title insurance contracts to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage arising out of defects in, liens on, or challenges to their title to real estate.

Variable annuity contract

An annuity in which the amount of payments to be made are specified in units, rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

Whole-life contract

Insurance that may be kept in force for a person's entire life by paying one or more premiums. It is paid for in one of three different ways: (a) ordinary life insurance (premiums are payable as long as the insured lives), (b) limited-payment life insurance (premiums are payable over a specified number of years), and (c) single-premium life insurance (a lump-sum amount paid at the inception of the insurance contract). The insurance contract pays a benefit (contractual amount adjusted for items such as policy loans and dividends, if any) at the death of the insured. Whole-life insurance contracts also build up nonforfeiture benefits.

APPENDIX B

Background Information and Summary of Consideration of Comments on Exposure Draft

67. As discussed in Statement 32, the FASB is extracting the specialized[9] accounting and reporting principles and practices from AICPA SOPs and Guides on accounting and auditing matters and issuing them as FASB Statements after appropriate due process. This Statement extracts without significant change the specialized principles and practices relating to insurance enterprises from the AICPA Industry Audit Guides, *Audits of Stock Life Insurance Companies* and *Audits of Fire and Casualty Insurance Companies;*[*] and AICPA SOPs 78-6, 79-3, and 80-1; and Opinion 23. Accounting and reporting standards that apply to enterprises in general also apply to insurance enterprises, and the standards in this Statement are in addition to those standards.

68. Board members have assented to the issuance of this Statement on the basis that it is an appropriate extraction of existing specialized principles and practices and that a comprehensive reconsideration of those principles and practices was not contemplated in undertaking this FASB project. Most of the background material and discussion of accounting alternatives have not been carried forward from the AICPA insurance industry related Guides and SOPs. The Board's conceptual framework project on accounting recognition criteria will address recognition issues relating to elements of financial statements. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

69. This Statement does not address issues that currently are being studied by the insurance industry and the accounting and actuarial professions. Some of those issues include:

a. What financial accounting and reporting principles should mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies follow in their general-purpose financial statements?

b. How should universal life insurance contracts and similar products that have been developed since the AICPA insurance industry related Guides and SOPs were originally issued be accounted for?

c. For short-duration contracts:

   (1) Should certain claim liabilities be discounted?

   (2) Should anticipated investment income be considered in determining if a premium deficiency exists?

d. What circumstances constitute a transfer of economic risk under a reinsurance contract?

70. An Exposure Draft of a proposed FASB Statement, *Accounting and Reporting by Insurance Enterprises,* was issued on November 18, 1981. The Board received 56 comment letters in response to the Exposure Draft. Certain

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[9] The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

[*] [Note—Superseded by *Audits of Property and Liability Insurance Companies,* December 15, 1990.]

of the comments received and the Board's consideration of them are discussed in this appendix.

Criteria for Distinguishing between Short-Duration and Long-Duration Contracts

71. Respondents commented on the appropriateness of the proposed criteria for distinguishing between short-duration and long-duration contracts and on whether the criteria could be improved. Some respondents said that the criteria were not well defined and could result in unintended changes in current accounting principles or practices because the criteria focused too narrowly on whether an insurance contract can be expected to remain in force for an extended period. They suggested that the criteria be clarified so that the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract is considered.

72. Other respondents recommended that (a) accounting for insurance contracts should depend on the type of insurance enterprise issuing the contract, (b) the criteria for distinguishing between the two types of contracts should be based on the period of the contract, or (c) contracts should be specified by type of insurance protection that should be considered short-duration or long-duration so that the Statement can be specifically applied without exception or ambiguity.

73. In extracting the specialized principles and practices from the AICPA insurance industry related Guides and SOPs, the Board decided to establish a framework for accounting by insurance enterprises based on the nature of insurance contracts rather than type of insurance enterprise. The Board concluded that the criteria for distinguishing between short-duration and long-duration contracts should be clarified so that the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract is considered, because that is consistent with (a) a general framework, (b) the principles in the AICPA insurance industry related Guides and SOPs, and (c) current practice.

Impairment in Value of Publicly Traded Securities

74. If an investment in a publicly traded security is reduced to its net realizable value, paragraph 51 requires that a gain not be recognized until the sale, maturity, or other disposition of the investment. Some respondents argued that permanent impairment is too absolute and often cannot be determined until after the event causing the impairment has occurred. In addition, they said that accounting for impaired amounts relating to publicly traded securities should be consistent with accounting for mortgage loans and real estate investments and reflective of an insurance enterprise's estimate of its ability to recover the carrying amount of those securities. They suggested that a standard consistent with Statement 5 be included to require adjustments of the carrying amount as circumstances change.

75. Other respondents agreed with paragraph 51 because it is an accurate extraction of SOPs 78-6, 79-3, and 80-1 and is consistent with principles and practices applicable to enterprises in other industries. Based on that reasoning, the Board concluded that adjustments for increases in value of previously impaired publicly traded securities should continue to be proscribed.

Acquisition Costs: Primarily versus Directly Related

76. Some respondents commented on the definition in paragraph 28 that states that acquisition costs are those costs that vary with and are *primarily* related to the acquisition of new and renewal insurance contracts. They pointed out

that, while the term *primarily* currently is used in practice by life insurance enterprises, the term *directly* is used in practice by property and liability insurance enterprises. They said that using the term *primarily* for all insurance enterprises could produce a different result for property and liability insurance enterprises. They recommended that the distinction between *primarily* and *directly* be retained in prescribing accounting principles for acquisition costs.

77. The Board believes that accounting principles and practices should not be applied differently among insurance enterprises without differences in underlying circumstances. Because the term *primarily* encompasses *directly*, the Board acknowledges that use of the term *primarily* might allow property and liability insurance enterprises to adopt broader guidelines in defining acquisition costs that are capitalizable. However, the Board believes that the use of the term *primarily* should not cause insurance enterprises to change their methods of defining acquisition costs to be capitalized.

Disclosure of the Average Rate of Assumed Investment Yields

78. Respondents commented on the benefits and costs of specifically requiring a disclosure of the average rate of assumed investment yields used in estimating the liability for future policy benefits. Some respondents said that disclosure of the average rate of assumed investment yields should be required because the disclosure would be relevant to users in assessing the reasonableness of estimated rates of return in relation to current investment yields and in comparing insurance enterprises. They also expressed the view that the cost to the reporting enterprise would be minimal and that the benefit to users of insurance enterprise financial statements would outweigh the related cost.

79. Other respondents said it is likely that the development of a single average interest rate would involve a time-consuming and costly process that would not be justified by the benefit. They also argued that the weighted average of interest rate assumptions has little meaning when there are other significant assumptions that also must be considered in estimating the liability for future policy benefits and that the disclosure would likely result in a general perception that the rate possessed more significance and value than deserved.

80. The Board agrees with those respondents that said disclosure of the average rate of assumed investment yields is useful in assessing the reasonableness of estimated rates of return in relation to current investment yields and in comparing insurance enterprises. However, because of uncertainties relating to the cost of providing that disclosure, the Board decided to encourage but not require disclosure of that yield rate.

Disclosure of Discounting Short-Duration Contract Claim Liabilities and Considering Anticipated Investment Income in Determining Premium Deficiencies

81. The Exposure Draft would have required disclosure of (a) the effects (including amounts) of discounting short-duration contract claim liabilities and (b) the effects (including amounts) of an enterprise's considering anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists. Some respondents said that insurance enterprises generally are not disclosing *amounts* in their notes because they believe disclosure of amounts is not required in the AICPA insurance industry related Guides and SOPs, which require disclosure of only the *effects*. Other respondents recommended that the Exposure Draft be revised to require disclosure of the carrying amount of claim liabilities carried at present value in the balance

sheet, the range of interest rates used to discount the claim liabilities, and the period of years over which the claims are being paid.

82. The phrase *including amounts* was included in the Exposure Draft to clarify what the Board understands was meant by *effects on the financial statements* in SOP 78-6. The Board believes that quantitative disclosures relating to the discounting of short-duration claim liabilities is necessary and, accordingly, decided to require disclosure of the carrying amount of short-duration contract liabilities that are presented at present value and the range of discount rates. However, the Board agreed that disclosure of amounts relating to an insurance enterprise's consideration of anticipated investment income in determining whether a premium deficiency exists is not necessary, and decided to require disclosure of only whether the insurance enterprise considers anticipated investment income in making that determination.

Disclosure of Statutory Requirements

83. With respect to the proposed disclosure of information relating to statutory capital and surplus requirements, some respondents suggested that disclosure be limited to the amount of statutory capital and surplus, minimum statutory requirements when significant, and statutory limitations on the payment of dividends. Other respondents recommended that the proposed disclosures parallel those in the SEC's recent revision of Article 7 of Regulation S-X. The Board agreed that the disclosure relating to statutory requirements needed clarification and revised the disclosure in accordance with the first sentence of this paragraph.

Reconciliation Disclosure

84. Respondents commented on whether disclosure of a reconciliation between financial reporting and statutory capital and income should be required. Some respondents said the disclosure should be required because the differences between statutory accounting practices and generally accepted accounting principles are an important element in the analysis of an insurance enterprise's general-purpose financial statements. They pointed out that statutory accounting determines the amount of dividends that can be paid as well as the sufficiency of statutory capital and surplus for regulatory purposes and, therefore, is important to users of insurance enterprise financial statements.

85. Other respondents said the reconciliation disclosure should not be required because the original purpose of the reconciliation was intended principally to provide relevant information during the life insurance industry's transition from statutory reporting. They also said that the disclosure may cast doubt on the appropriateness of accounting principles used in the general-purpose financial statements.

86. The Board believes that the disclosure in paragraph 60(h) relating to statutory requirements is sufficient for the general-purpose financial statements of insurance enterprises.

Other Comments

87. Some respondents noted that paragraph 10 of the Exposure Draft would require a liability for claim adjustment expenses to be accrued when insured events occur and that life insurance enterprises currently are not accruing those costs. They said that accruing claim adjustment expenses associated with unpaid claims would require an accounting change for life insurance enterprises and that, although it may be appropriate to require life insurance enterprises to accrue a liability for those costs, those enterprises should be excluded from that requirement since the AICPA stock life insurance guide

does not require that accrual. However, they acknowledged that the change is not likely to significantly affect the financial statements of life insurance enterprises. The Board believes that the requirement is appropriate and that it meets a criterion for change—that is, practices among insurance enterprises are different without differences in circumstances. In addition, the Board believes the requirement is consistent with the provisions of Statement 5.

88. Several respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of some of the provisions of the Guides and SOPs. Such a reconsideration is not contemplated in the extraction project unless a proposed change meets one of the three criteria for change included in the "Notice for Recipients" of the Exposure Draft or is broadly supported. The proposed changes did not met the criteria for change and were not broadly supported. Accordingly, the Board did not adopt those suggestions. However, based on suggestions from respondents to the Exposure Draft, the Board has made several other changes that it believes clarify the Statement.

89. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 64 and 65 are advisable in the circumstances.

Appendix I

Auditing Standards Division

Statement of Position

Auditing Life Reinsurance

Supplements *Audits of Stock Life Insurance Companies*

November 1984

Prepared by the Reinsurance Auditing and Accounting Task Force
American Institute of Certified Public Accountants

Auditing Life Reinsurance

Applicability

1. This statement provides guidance on auditing life reinsurance. Guidance on auditing property and liability reinsurance, including accident and health reinsurance, is provided in the statement of position entitled, *Auditing Property and Liability Reinsurance,* issued by the AICPA Auditing Standards Division in October 1982.

Introduction

2. When an insurance company issues life insurance policies, it undertakes a number of risks relating to the ultimate profitability of the policies, such as adverse experience regarding mortality or terminations, inadequate investment earnings, and unanticipated costs. Reinsurance is the assumption by one insurer (the assuming company) of all or part of the risks originally undertaken by another insurer (the ceding company).

3. Each life insurance company determines its *retention limit,* which represents the maximum loss exposure acceptable to the company that could result from the death of any individual insured by the company. The retention limit will vary depending on the age of the insured at issuance of the policy, the type of insurance plan involved, and whether the insured is classified as a standard or substandard risk. If the policy exceeds the retention limit, the company will reinsure the excess portion of the risk. A company may also reinsure part or all of a policy within its retention limit if the company sees a need to limit its risk.

4. Reinsurance also provides a means for the company to meet certain other objectives such as to avoid "surplus strain" resulting from the statutory accounting treatment of expenses and reserves, to reduce fluctuations in claim experience or to stabilize mortality cost, to provide additional capacity to accept business that would otherwise have to be declined, to protect solvency, to obtain underwriting assistance regarding risk classification, or to assist in financial and tax planning strategies.

5. By ceding all or part of the risk, the ceding company does not discharge its primary obligations to its insureds. Therefore, the ceding company is concerned with the ability of the assuming company to honor its commitments under the reinsurance contract. The assuming company, on the other hand, is concerned with the accuracy and reliability of the information received from the ceding company regarding the risks it has assumed and, in some circumstances, the ability of the ceding company to honor commitments to the assuming company. Factors that are pertinent to the auditor's evaluation of reinsurance contracts include the types of reinsurance agreements and the consequent nature of the risks transferred, contractual safeguards in the reinsurance agreements, and internal control structure regarding reinsurance maintained by the ceding company or by the assuming company.

6. Reinsurance may be transacted through—

a. *Facultative agreements,* whereby each risk or portion of a risk is reinsured individually, the assuming company having the option to accept or reject it.

b. *Automatic agreements,* whereby an agreed portion of business written is automatically reinsured, thus eliminating the need to submit each risk to the assuming company for acceptance or rejection.

7. Life reinsurance contracts generally take one of three forms: yearly renewable term, coinsurance, or modified coinsurance.

a. *Yearly renewable term (YRT)* reinsurance involved the purchase of reinsurance on the policyholder's life on a year-by-year basis. Typically the amount of reinsurance provided and the reinsurance premium charged for a particular contract will change from year to year on a scheduled basis. The reinsurance premium will depend on factors such as the age and sex of the insured, the duration of the policy, and the underwriting classification (standard or substandard risks). Yearly renewable term reinsurance generally transfers only the mortality risk to the assuming company.

b. *Coinsurance* differs from yearly renewable term reinsurance in that the assuming company participates in substantially all aspects of the original policy and in that the contract generally covers a longer period of time. The assuming company will receive its share of the policy premiums and pay its share of the face amount of claims and cash values on terminations. The assuming company will establish its share of the statutory policy reserves, and the ceding company will reduce its reserves for the portion reinsured. If the policy is participating, the assuming company will generally reimburse the ceding company for its share of the policyholder dividend. The assuming company also generally reimburses the ceding company for its commission outlay and usually pays an additional amount toward the ceding company's expenses. The assuming company ordinarily participates in the risks regarding investment, mortality, terminations, and other risks of the policy.

c. *Modified coinsurance* differs from coinsurance only in that the reserves and the assets supporting the reserves remain with the ceding company. In addition to the transactions required by coinsurance, a "reserve adjustment" payment between the assuming and ceding companies is made each year. The assuming company will be paid interest on the assets supporting the reserves according to a specified formula, which may involve a fixed rate or may be related to the interest earnings of the ceding company. Depending on the formula, the investment risk may be borne by the ceding company or the assuming company, or it may be shared. As with coinsurance, the assuming company ordinarily participates in the mortality, termination, and other risks.

8. Life insurance companies may also purchase *nonproportional reinsurance* on all or part of their insurance. One form of nonproportional reinsurance is stop-loss, under which the assuming company agrees to reimburse the ceding company for aggregate losses that exceed a specified amount. Another form is catastrophe reinsurance, under which the assuming company agrees to reimburse the ceding company for losses in excess of a specified amount that result from a single accident.

9. Reinsurance agreements often provide for participation by the ceding company in the profits generated under the reinsurance. The reinsurance agreement will specify the method of computing the profit and the formula for sharing it.

10. Typically, reinsurance agreements are individually negotiated and tailored to the needs and objectives of the ceding and assuming companies.

The foregoing descriptions of life reinsurance agreements are not exhaustive, and variations from the described approaches are common.

Generally Accepted Accounting Principles

11. The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. With certain exceptions, the amounts for reinsurance transactions are netted against the related accounts in financial statements. The accounting entries for reinsurance assumed normally parallel those for direct insurance.[1]

12. FASB Statement No. 60* describes reporting in conformity with generally accepted accounting principles for "payments to insurance companies that may not involve transfer of risk." Similar guidance is provided in FASB Statement No. 5, *Accounting for Contingencies,* paragraph 44. Paragraph 40 of FASB Statement No. 60* states—

> To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

Scope

13. The following sections describe certain significant aspects of internal control structure regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* states "Establishing and maintaining an internal control structure is an important management responsibility." The concept of reasonable assurance is inherent in management's determination of the nature and extent of internal control structure, and the elements of audit risk and materiality underlie the application of generally accepted auditing standards by the independent auditor.

Ceded Reinsurance

Internal Control Structure of the Ceding Company

14. The ceding company should have those internal control structure policies and procedures that it considers necessary to (*a*) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (*b*) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may vary, depending on

[1] FASB Statement No. 60,* *Accounting and Reporting by Insurance Enterprises,* specifies certain accounting and disclosure requirements for reinsurance.

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992.

the type of contracts (such as yearly renewable term and coinsurance) and other factors, and may include [2]

a. Obtaining and analyzing recent financial information of the assuming company, such as—
- Financial statements and, if the statements are audited, the independent auditor's report.
- Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
- Financial statements, including the actuary's opinion, filed with insurance regulatory authorities, with particular consideration of the quality and liquidity of the company's invested assets.

b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
- Insurance industry reporting and rating services.
- Insurance department examination reports.
- Letters relating to the adequacy of internal accounting controls filed with regulatory authorities.
- Insurance Regulatory Information System results filed with regulatory authorities.

c. Inquiring about the assuming company's retrocessional practices and experience.

d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.

e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.

f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

15. The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

Auditing Procedures

16. The independent auditor's consideration of the ceding company's internal control structure ordinarily should include a review of the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned.

17. The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding

[2] The absence of one or more specific control procedures does not necessarily indicate a weakness in the internal control structure.

company's internal control structure.[3] If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as receivables or reductions of liabilities that are recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph 14, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, *Reports on Audited Financial Statements,* paragraphs 40 through 48, and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

18. Reinsurance of life insurance permits the elimination of the reinsured portion of the related liability for future policy benefits from the ceding company's financial statements. Under certain circumstances, reinsurance may also result in increasing current earnings or investable funds to the extent that the proceeds received from the assuming company exceed expenses incurred in connection with the sale and servicing of the reinsured policies. The auditor of the ceding company ordinarily should confirm insurance policies in force with policyholders when ceded reinsurance activities can materially increase current earnings or investable funds. (See the statement of position entitled *Confirmation of Insurance Policies in Force,* issued by the AICPA Auditing Standards Division, August 1978.)

19. To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

a. Read the reinsurance contract and related correspondence to—
   - Obtain an understanding of the business objective of the reinsurance contract.
   - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,* paragraph 40 (see paragraph 12 above).

b. Trace entries arising from selected reinsurance contracts to the appropriate records.

c. Trace the selected transactions to supporting documents and test related receivables and payables.

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[3] SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* states, "A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." SAS No. 60 requires the auditor to communicate to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, reportable conditions, including material weaknesses in the internal control structure that come to his or her attention during an audit.

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992.

d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Assumed Reinsurance

Internal Control Structure of the Assuming Company

20. A significant element of the assuming company's internal control structure related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). The appropriate control procedures may vary depending on the type of contracts (such as yearly renewable term and coinsurance) and other factors. Principal control procedures of the assuming company may include [4]

a. Maintaining information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract, such as—
- Actuarial studies of the business assumed.
- Anticipated profitability.
- Anticipated termination rates.
- Prior business experience with the ceding company.
- The assuming company's experience on similar business.
- Information regarding pricing and ceding commissions.
- An indication of the frequency and content of reports from the ceding company.

b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.

c. Visiting the ceding company and reviewing and evaluating its sales, underwriting, benefits processing, and actuarial policies and procedures.

d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal accounting controls relating to ceded reinsurance (see SAS No. 30,* *Reporting on Internal Accounting Control,* paragraphs 60 and 61). If the ceding company's independent auditor confirmed life insurance policies in force (see paragraph 18), the assuming company might also consider obtaining a special report from the ceding company's independent auditor regarding the results of those confirmation procedures.

21. Additional control procedures of the assuming company may include—

a. Obtaining and analyzing recent financial information of the ceding company, such as—
- Financial statements and, if audited, the independent auditor's report.

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[4] See footnote 2.

* On April 20, 1992, the AICPA's Auditing Standards Board issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting.* The Statement would supersede SAS No. 30. A final Statement is expected to be issued in 1993.

- Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
- Financial statements, including the actuary's opinion, filed with regulatory authorities.

b. Obtaining and reviewing available sources of information on the ceding company, such as—
- Insurance industry reporting and rating services.
- Insurance department examination reports.
- Letters relating to the adequacy of internal control structure filed with regulatory authorities.
- Insurance Regulatory Information System results filed with regulatory authorities.

c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

Auditing Procedures

22. The independent auditor's consideration of the assuming company's internal control structure ordinarily should include a review of the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned.

23. The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's internal control structure.[5] If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

a. Performing procedures such as certain of the procedures specified in paragraph 20

b. Visiting the ceding company's independent auditor and reviewing his working papers (see SAS No. 1, section 543.12, *Part of Audit Performed by Other Independent Auditors*)

c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures

d. Obtaining the report of the ceding company's independent auditor on policies and procedures (related to ceded reinsurance) placed in operation and tests of operating effectiveness (see SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*)

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a

[5] See footnote 3.

scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

24. To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

a. Read the reinsurance contract and related correspondence to—
- Obtain an understanding of the business objective of the reinsurance contract.
- Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,* paragraph 40 (see paragraph 12 above).

b. Trace entries arising from selected reinsurance contracts to the appropriate records.

c. Trace selected transactions to supporting documents and test the related receivables and payables.

d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Effective Date

25. This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position will be effective for audits made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1985.

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* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992.

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies),
Audits of Property and Liability Insurance Companies, and
Audits of Stock Life Insurance Companies

Issued by the
Accounting Standards Executive Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

Scope

1. This statement of position provides guidance for disclosure by financial institutions of certain information about debt securities held as assets. It applies to financial institutions whose policy is to carry such securities either at historical cost or at the lower of cost or market value. Such financial institutions include banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies. Entities other than financial institutions that include financial institution subsidiaries in their consolidated financial statements should provide the disclosures required by this statement for debt securities held as assets by such subsidiaries.

2. As used in this statement, *debt securities* include—

- Bills, notes, and bonds issued by—
  - *a.* The federal, state, and local governments in the United States and agencies and authorities of those governments.
  - *b.* Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations, including collateralized bond obligations and interest-only and principal-only strips of such bonds and commercial paper.
- Mortgage-backed and other securitized debt instruments, including collateralized mortgage obligations[1] and principal-only and interest-only strips of such instruments.

Debt securities also include preferred stock that, by its terms, either must be redeemed by the issuing enterprise or is redeemable at the option of the investor because, for the purposes of this statement, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans; notes and bonds of foreign governments classified as loans; and unsecuritized leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this statement.

3. This statement amends the following AICPA industry audit and accounting guides:

- *Audits of Banks*
- *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*
- *Audits of Property and Liability Insurance Companies*
- *Audits of Stock Life Insurance Companies*

Background

4. On May 25, 1990, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed statement of position, *Report-*

[1] For purposes of this statement, collateralized mortgage obligations also include instruments issued in equity form that are required to be accounted for as nonequity instruments under the consensus on Emerging Issues Task Force Issue 89-4.

ing by Financial Institutions of Debt Securities Held as Assets. That exposure draft was issued in response to concerns that the guidance on reporting debt securities held as assets in the AICPA audit and accounting guides for the various financial industries is uniform for particular industries but is inconsistent from industry to industry. Further, changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate and other risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased purchases and sales of debt securities classified as investments, which have contributed to diversity in the application of that guidance.

5. Regulators of financial institutions have expressed concern about certain activities concerning securities classified as investments. Such activities are described in the April 14, 1988, Banking Circular, *Selection of Securities Dealers and Unsuitable Investment Practices,* which is reproduced in Appendix B.

6. The exposure draft recommended guidance on reporting debt securities held as investment assets that attempted to make more workable the assessment of the ability and intent to hold such securities that is required under current literature. However, comment letters on the exposure draft raised significant questions about the subjectivity of the guidance, and AcSEC concluded that the proposal needed to be studied further.

7. The exposure draft proposed disclosures about debt securities held as assets, and many commentators recommended expanded disclosures as an interim solution. This statement is intended to be such an interim solution.

Conclusions

8. Financial institutions should include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into balance sheet captions, such as investment or trading.

9. Financial institutions should also disclose in the notes to their financial statements the following information concerning debt securities carried at either historical cost or the lower of cost or market value[2]:

- For each balance sheet presented, the amortized cost [3], estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are the following:
  - — Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
  - — Debt securities issued by states of the U.S. and political subdivisions of the states
  - — Debt securities issued by foreign governments and not classified as loans
  - — Corporate securities
  - — Mortgage-backed securities

[2] If a financial institution carries some debt securities at amortized cost and others at the lower of cost or market value and it reports them in separate balance sheet captions, these disclosures should be presented for each caption.

[3] Amortized cost is the face amount of the debt security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the balance sheet, if different.

— Other debt securities

- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due—
  a. In one year or less
  b. After one year through five years
  c. After five years through ten years
  d. After ten years[4]
- For each period for which results of operations are presented, the proceeds from sales[5] of such debt securities and gross realized gains and gross realized losses on such sales

Effective Date and Transition

10. This statement is effective for financial statements for fiscal years ending after December 15, 1990. This statement need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are being provided with financial statements for fiscal years ending after its effective date.

[4] Securities not due at a single maturity date, such as mortgage-backed securities, may be included in a separate category. If such securities are not included in a separate category, the method used for inclusion in the maturity table should be disclosed.

[5] As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this statement, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

APPENDIX A

Illustrative Financial Statement Disclosure

Investment Securities

The amortized cost and estimated market values of investments in debt securities are as follows: [a]

	Amortized Cost [b]	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$XXXXX	$XXX	$(XXX)	$ XXXXX
Obligations of states and political subdivisions	XXXXX	XXX	(XXX)	XXXXX
Debt securities issued by foreign governments	XXXXX	XXX	(XXX)	XXXXX
Corporate securities	XXXXX	XXX	(XXX)	XXXXX
Mortgage-backed securities	XXXXX	XXX	(XXX)	XXXXX
Other debt securities	XXXXX	XXX	(XXX)	XXXXX
Totals	$XXXXX	$XXX	$(XXX)	$ XXXXX

The amortized cost and estimated market value of debt securities at December 31, 19XX, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

[a] This information should be provided for each balance sheet presented that is dated after December 15, 1990.
[b] See footnote 3.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ XXX	$ XXX
Due after one year through five years	XXX	XXX
Due after five years through ten years	XXX	XXX
Due after ten years	XXX	XXX
	XXXX	XXXX
Mortgage-backed securities	XXX	XXX
	$XXXXX	$XXXXX

Proceeds from sales of investments in debt securities during 19XX were $______. Gross gains of $______ and gross losses of $______ were realized on those sales.[c]

[c] This information should be provided for each period for which results of operations are presented for periods ending after December 15, 1990.

APPENDIX B

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES *

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- a consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

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* This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.

- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE-BACKED SECURITIES, RESIDUALS, AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement No. 91 (FAS No. 91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS No. 91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset-Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

Appendix K

Statement of Position 92-3

Accounting for Foreclosed Assets

April 28, 1992

Issued by the
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This statement of position (SOP) provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. It applies to all reporting entities, except those that account for assets at fair value or market value. It applies to all assets obtained through foreclosure or repossession, except for inventories, marketable equity securities, and real estate previously owned by the lender and accounted for under FASB Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP recommends that foreclosed assets held for sale be carried at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost. Foreclosed assets held for the production of income should be treated the same way they would be had the assets been acquired in a manner other than through foreclosure.

The SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992.

Accounting for Foreclosed Assets

Scope

1. This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets [1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for *(a)* inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins; (b)* marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities;* and *(c)* foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.* Except for the requirements in paragraphs 12 and 17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix).

Background

2. Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

3. The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies* requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and in the Industry Audit Guide *Audits of Finance Companies* are consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide *Audits of Banks* states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* does not address accounting for foreclosed assets.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

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[1] As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.* It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

7. Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

8. AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

9. This SOP affects the following AICPA statements of position and industry audit and accounting guides:

- *a.* SOP 75-2, *Accounting Practices of Real Estate Investment Trusts,* paragraphs 15-23, 25, 27, 28, 29*a*, 29*b*, and 29*c*
- *b.* SOP 78-2, *Accounting Practices of Real Estate Investment Trusts,* paragraph 6
- *c.* *Audits of Banks*
- *d.* *Audits of Savings Institutions*
- *e.* *Audits of Finance Companies*
- *f.* *Audits of Property and Liability Insurance Companies*
- *g.* *Audits of Stock Life Insurance Companies*
- *h.* *Guide for the Use of Real Estate Appraisal Information*

Conclusions

Held-for-Sale Presumption

10. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

11. The presumption of sale can be rebutted if (*a*) management intends to hold a foreclosed asset for the production of income, (*b*) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (*c*) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

12. After foreclosure, foreclosed assets held for sale should be carried at the lower of (*a*) fair value[2] minus estimated costs to sell or (*b*) cost.[3] Such determination should be made on an individual asset basis. If the fair value of

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[2] *Fair value,* as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the *expected cash flows are* discounted at a rate commensurate with the risk involved.[6]
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> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21,* "Interest on Receivables and Payables," and paragraph 25 of *APB Opinion No. 29,* "Accounting for Nonmonetary Transactions."

[3] The *cost* of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix).

the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[4]

13. The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

14. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects;* SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs,* and the AICPA Industry Audit Guide *Accounting for Retail Land Sales.* These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

15. After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

16. If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

17. This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of *(a)* the fair value of the asset minus the estimated costs to sell the asset or *(b)* the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of

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[4] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

APPENDIX

Discussion of Major Comments on the Exposure Draft

A-1. This Appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* requires the subsidiary to be consolidated unless control is likely to be temporary.

Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

Concept of Fair Value

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that *(a)* only the form of the asset is changed by foreclosure or repossession, *(b)* the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and *(c)* foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which *(a)* an asset is transferred between debtor and creditor, *(b)* the creditor relinquishes all or part of its claim against the debtor, and *(c)* the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21,* and *No. 29,* which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows*

from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2*[31] is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.

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[31] See paragraphs 59 and 60 of this Statement.

Results of Operations Related to Foreclosed Assets Held for Sale

A-6. In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to forelosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

A-7. AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.

Foreclosed Assets Held for the Production of Income

A-8. In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

Change in Classification

A-9. AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

In-Substance Foreclosed Assets

A-10. Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs 12 and 17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.

b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed;* and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost.

Carrying Amount of Assets at Foreclosure

A-11. Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

A-12. Some respondents also said that the definition of *fair value*, which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to being principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

Offsetting of Debt

A-13. Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

Transaction

A-14. Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

Appendix L

Schedule of Changes Made to Audits of Stock Life Insurance Companies

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Text modified.	May, 1992
Paragraph 1.03	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraphs 2.36 and 2.37	Notation of loss of SEC exemptions added.	October, 1990
Paragraph 3.32	Reference to FASB Statement No. 113 added.	May, 1993
Paragraph 3.70	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 4.11	Note reference added to reflect the issuance of SOP 92-3.	May, 1992
Paragraphs 6.08 and 6.20	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraphs 6.47 and 6.48	Notation of significant revision to taxation of life insurance companies added.	October, 1990
Paragraph 7.06	Notation of change in accounting for realized gains and losses added.	October, 1990
Paragraph 8.09	Reference to SAP No. 33 changed to SAS No. 1, section 544, paragraph 2.	October, 1990
Paragraphs 8.12, 8.13 and 8.14	Notation of issuance of FASB Statement No. 97 added.	October, 1990
Paragraph 8.94	Notation of issuance of FASB Statement No. 109 added.	May, 1992
Paragraphs 8.96 and 8.97	Notation of issuance of FASB Statement No. 97 added.	October, 1990
Paragraph 8.98	Notation of issuance of FASB Statement No. 97 added; Reference to *Audits of Fire and Casualty Insurance Companies* deleted; Reference to exposure draft changed to Audit and AcDHcounting Guide, *Audits of Brokers and Dealers in Securities.*	October, 1990
Paragraph 8.99	Notation of issuance of FASB Statement No. 97 added; Reference to FASB Statement No. 60 added.	October, 1990
Paragraph 8.100	Notation of issuance of FASB Statement No. 97 added.	October, 1990

Reference	Change	Date
Paragraph 8.104	Reference to FASB Statement No. 94 added; Reference to SEC Rule 4-07 of Regulation S-X changed to Rules 3A-02 and 3.09.	October, 1990
Paragraphs 9.40 and 9.41	Note reference to FASB Statement No. 109 added.	May, 1992
Paragraph 9.43	Reference to SAP No. 51 changed to SAS No. 1, section 332.	October, 1990
Paragraph 10.01	Reference to and quote from SAP No. 33 changed to reference to and quote from SAS No. 32.	October, 1990
Paragraphs 10.09, 10.10, 10.11, 10.12, 10.13, 10.14, 10.15 and 10.16	Reference to FASB Statement No. 60 added.	October, 1990
Paragraph 10.18	Reference to FASB Statement No. 113 added.	May, 1993
Appendix A (Statement of Income and Notes to Statement of Income)	Note reference of the significance of changes due to FASB Statement No. 97 added.	October, 1990
Appendix A (Statement of changes in Financial Position)	Note reference to FASB Statement No. 95 added.	October, 1990
Appendix A (Supplementary Data, Statement of Adjustments to Arrive at Net Income, and Statement of Adjustments to Arrive at Stockholders' Equity)	Note reference of the supersession of the section of FASB Statement No. 97 requiring reconciliation added.	October, 1990
Appendix A (Notes)	Note reference to FASB Statement No. 95 added; Note reference to the cessation of presenting GAAP financial statements added.	October, 1990
Appendix C	Notation of significant revisions to taxation of life insurance companies added.	October, 1990
Appendix C	Note reference revised to reflect the issuance of FASB Statement No. 109.	May, 1992
Appendix D	Conformed to the terminology used in SAS No. 55.	May, 1992

Reference	Change	Date
Appendix G	The Term "Ethics" has been changed to "Conduct" to conform to the terminology used in the AICPA Code of Professional Conduct.	October, 1990
Appendix G	Revised to reflect the supersession of certain FASB Statement No. 60 paragraphs.	May, 1992; May, 1993
Appendix H (Paragraph 6)	Reference to FASB Statement No. 97 added.	October, 1990
Appendix H (Paragraph 15)	Notation of the supersession of the paragraph by FASB Statement No. 97 added.	October, 1990
Appendix H (Paragraphs 38, 39, and 40)	Notation of supersession by FASB Statement No. 113 added.	May, 1993
Appendix H (Paragraph 49)	Notation of supersession of FASB Statement No. 91 added.	October, 1990
Appendix H (Paragraph 50)	Notation of the supersession of the paragraph's first sentence by FASB Statement No. 97 added.	October, 1990
Appendix H (Paragraphs 55, 56, 57, 58, 60 i(2), and 60 j)	Notation of the supersession of the paragraph by FASB Statement No. 96 added.	October, 1990
Appendix H (Paragraph 60f)	Notation of supersession by FASB Statement No. 113 added.	May, 1993
Appendix H (Paragraph 63)	Reference to FASB Statement No. 97 added.	October, 1990
Appendix H (Paragraph 67)	Note reference of the supersession of *Audits of Fire and Casualty Insurance Companies* by Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* added.	October, 1990
Appendix I (Paragraph 5)	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix I (Paragraphs 12 and 13)	Note reference to FASB Statement No. 113 added.	May, 1993
Appendix I (Paragraphs 13, 14, and 16)	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix I (Paragraph 17)	Reference to SAS No. 2, paragraphs 10 through 13 changed to SAS No. 58, paragraphs 38 through 66 and 70 through 72.	October, 1990
Appendix I (Paragraph 17)	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix I (Footnote to Paragraph 17)	Conformed to the terminology used in SAS No. 60.	May, 1992

Reference	Change	Date
Appendix I (Paragraph 19)	Note reference to FASB Statement No. 113 added.	May, 1993
Appendix I (Paragraph 20)	Note reference to proposed SSAE added.	May, 1993
Appendix I (Paragraphs 20—23)	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix I (Paragraph 23b)	Title of SAS No. 1, section 543, changed to conform to SAS No. 58 terminology.	November, 1991
Appendix I (Paragraph 23d)	Conformed to SAS No. 70.	May, 1993
Appendix I (Paragraph 24)	Note reference to FASB Statement No. 113 added.	May, 1993
Appendix J	SOP 90-11 added.	March, 1991
Appendix J	References to Audit and Accounting Guide *Savings and Loan Associations* deleted.	August, 1991
Appendix J	References to Audit and Accounting Guide *Audits of Credit Unions* deleted.	February, 1993
Appendix K	SOP 92-3 added.	May, 1992
Appendix K	References to Audit and Accounting Guide *Audits of Credit Unions* deleted.	February, 1993

In addition to the above, notes have been added to highlight areas that will be updated in future editions. These areas include:

References in paragraphs 2.36 and 2.37 to exemptions from SEC filings that generally no longer exist may be eliminated.

Chapter 11, *Auditors' Reports,* will be conformed to SAS No. 58.

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